2007

FINANCE LAW CHANGES

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2007 Finance Law Changes

Bonds - Expand Special Purpose Projects.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-128	**SB 966**	**Senator Cowell**

AN ACT TO AUTHORIZE THE NORTH CAROLINA CAPITAL FACILITIES FINANCE AGENCY TO ISSUE BONDS FOR SALVAGE CENTERS, CERTAIN RESEARCH FACILITIES, AND INTERNATIONAL HEADQUARTERS OF NONPROFIT SCHOLARLY SOCIETIES.

OVERVIEW: This act adds three projects to the list of special projects for which the North Carolina Capital Facilities Financing Agency may issue bonds:

- Facilities for the provision of material salvage and recycling services, the proceeds of which are used to provide for low, moderate, or affordable housing.
- Facilities for the provision of research conducted by a nonprofit corporation organized by two or more accredited universities whose main campuses are located in North Carolina.
- Facilities for housing the international headquarters of a nonprofit scholarly society that is a member of the Scholarly Societies Project.

FISCAL IMPACT: Minimal impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective when signed into law by the Governor on June 27, 2007.

ANALYSIS: A private entity may obtain conduit financing under the Private Capital Facilities Finance Act from the North Carolina Capital Facilities Finance Agency[1] in order to acquire, construct, and improve a qualifying project. In a conduit financing, a governmental entity issues its bonds to finance facilities for a private party, then receives payments from the private party to service the bonds. The interest on the financing to the investor may be exempt from income tax under federal law if the entity is a 501(c)(3) organization and is exempt from income tax under State law under G.S. 159D-55. The advantage to private entities of tax-exempt financing is that interest rates on tax-exempt financing are significantly lower than on taxable financing. The financing agreement could include revenue bonds or some other forms of debt. The private entity must pay for the entire cost of the financing and of the facility being financed. In no event may the financing pledge the faith or credit of the State, a local government, or any political subdivision.

[1] Conduit financing is administered by the North Carolina Capital Facilities Financing Agency. The Agency is composed of seven members and is located in the Treasurer's Office. The Agency is audited annually and submits an annual report to the Governor and the General Assembly.

Projects that qualify for conduit financing under the Act include educational facilities, student housing facilities and special purpose projects as defined in G.S. 159C-3(15a). The term 'special purpose projects' includes water systems, sewage disposal systems, public transportation systems, public parking lots, auditoriums, convention centers, recreational facilities, solid waste disposal and recycling facilities, housing facilities for children or disabled persons, and facilities for rehabilitation services for disable persons. This act adds the following three projects to the list of projects defined as 'special purpose projects' under G.S. 159C-3(15):

- Facilities for the provision of material salvage and recycling services, the proceeds of which are used to provide for low, moderate, or affordable housing. Habitat for Humanity would meet this description. It operates Reuse Centers across the State where it sells new, used, and recycled building materials to the public and uses the proceeds for low, moderate, and affordable housing. There are five major reuse centers in the State. The reuse center in Wake County is planning to construct a reuse center, which includes administrative offices. The cost of the center is anticipated to be at least $4 million. If Habitat for Humanity is able to finance the construction of the facility through the North Carolina Capital Facilities Financing Agency, it will save tens of thousands of dollars. A similar organization, The Goodwill Industries, is already included in the list of special projects for which the Agency may issue bonds.
- Facilities for the provision of research conducted by a nonprofit corporation organized by two or more accredited universities whose main campuses are located in North Carolina. RTI International would meet this description. Currently, RTI International rents facility space. In the long-term, RTI will save money if it purchases its own facilities.
- Facilities for housing the international headquarters of a nonprofit scholarly society that is a member of the Scholarly Societies Project.[2] To be included in the Project, a society must generally be a membership-based society that has scholarly, academic, or research goals. The only scholarly society that is a member of the Project and has its international headquarters located in North Carolina is Sigma Xi. Sigma Xi, founded in 1886, is the international honor society of research scientists and engineers. The society currently owns a 52,000 square foot facility in the Research Triangle Park.

[2] The Scholarly Societies Project provides access to information about a significant number of scholarly societies worldwide.

<u>2007 Continuing Budget Authority.</u>

Session Law	*Bill #*	*Sponsor*
S.L. 2007-145	**HB 2044**	**Rep. Luebke, Gibson, Wainwright, Weiss**

AN ACT AUTHORIZING THE DIRECTOR OF THE BUDGET TO CONTINUE EXPENDITURES FOR THE OPERATION OF GOVERNMENT AT THE LEVEL IN EFFECT ON JUNE 30, 2007; APPROPRIATING FUNDS FOR INCREASES IN THE AVERAGE DAILY MEMBERSHIP IN THE PUBLIC SCHOOLS; EXTENDING THE PROVISION THAT PERMITS RETIRED TEACHERS TO RETURN TO THE CLASSROOM WITHOUT A LOSS OF RETIREMENT BENEFITS; DELAYING THE EFFECTIVE DATE OF CHANGES TO THE MEDICAID ESTATE RECOVERY PLAN; AND EXTENDING THE SUNSET ON THE ADDITIONAL ONE-QUARTER CENT STATE SALES AND USE TAX FROM JULY 1, 2007, UNTIL AUGUST 1, 2007.

<u>OVERVIEW:</u> Among other things, this act extended the sunset on the additional ¼ cent State sales tax rate from July 1, 2007, until August 1, 2007.

<u>FISCAL IMPACT:</u> The one-month extension of the sales tax rate at 4.25% resulted in an increase to the General Fund of roughly $20 million. *(For a more complete fiscal analysis, see Overview: <u>Fiscal and Budgetary Actions</u>, 2007 Session. Available in the Legislative Library.)*

<u>EFFECTIVE DATE:</u> The act became effective when signed into law by the Governor on July 29, 2007.

<u>ANALYSIS:</u> Section 9 of the act extended the sunset on the additional ¼ cent State sales tax rate until August 1, 2007. The extension kept the State sales tax rate at 4.25% until August 1, 2007. S.L. 2007-323 repealed the August 1, 2007, sunset, thus retaining the 4.25% State sales tax rate permanently.

The General Assembly increased the State sales tax rate from 4% to 4.5% in 2001. The increase was to sunset July 1, 2003. S.L. 2003-284 extended the sunset for two years to July 1, 2005. S.L. 2005-276 extended the sunset an additional two years to July 1, 2007. S.L. 2006-66 reduced the rate by ¼ cent earlier than was required under S.L. 2005-276 so that the State sales tax rate became 4.25%, effective December 1, 2006, with the tax rate expected to return to 4%, effective July 1, 2007. This act extended the 4.25% rate until August 1, 2007.

Revised Dist. of Scrap Tire Disposal Tax.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-153	**SB 1472**	**Senator Albertson**

OVERVIEW: This act, which was a recommendation of the Department of Environment and Natural Resources, amends the distribution of the net proceeds of the Scrap Tire Disposal Tax; it does not change the tax rate. It increases the percentage of net tax proceeds distributed to the Solid Waste Management Trust Fund from 5% to 8%, decreases the percentage distributed to the Scrap Tire Disposal Account from 27% to 22%, and increases the percentage distributed among the counties on a per capita basis from 68% to 70%.

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective July 1, 2007.

ANALYSIS: In the late 1980s, the General Assembly banned the landfilling of whole scrap tires and required each county to develop disposal procedures for scrap tires located within its boundaries. The Scrap Tire Disposal Tax, enacted in 1991, is a privilege tax levied on the retail sales of new tires for the purpose of providing a source of revenue to assist with their disposal.[3] The rate of tax depends upon on the size of the tire. It is 2% for tires that have a bead diameter of less than 20 inches and 1% for tires that have a bead diameter of 20 inches or more.[4] Sales of bicycle tires, recapped tires, and tires sold for placement on newly manufactured vehicles are exempt from the tax.

The net proceeds[5] of the tax are distributed among the Solid Waste Management Trust Fund, the Scrape Tire Disposal Account, and the counties. This act changes the distribution of the net proceeds of the tax revenue to more accurately reflect the current needs for the funding: less funding is needed for the cleanup of illegal or nuisance dump sites and more funding is needed by the Solid Waste Management Trust Fund to encourage market development and by counties to improve their ongoing disposal programs.

The act changes the distribution as follows:

- Increases from 5% to 8% the amount of the net tax proceeds credited to the Solid Waste Management Trust Fund. Monies in the Fund are used to promote waste reduction and recycling, research on the solid waste stream in North Carolina, and activities related to the development of secondary materials markets.
- Decreases from 27% to 22% the amount of the net tax proceeds credited to the Scrap Tire Disposal Account. Monies in the Account may be used to provide grants

[3] The tax is administered in the same manner as the State sales and use tax. The tax is also imposed on sales to wholesale merchants or retailers for placement of tires on a vehicle offered for sale, lease, or rental.

[4]The bead is that part of the tire that contacts the wheel. The bead is reinforced with steel wire, and compounded from high strength, low flexibility rubber. The bead seats against the wheel tightly to ensure that the tire holds air without leakage.

[5] The Department of Revenue retains $425,000 annually from the proceeds of the tax for administrative expenses. (S.L. 2007-323 increased this amount from $225,000 to $425,000, effective July 1, 2007.)

to local governments to assist them in disposing of scrap tires[6] provide grants to encourage the use of processed scrap tire materials, and clean up scrap tire collection sites.

- Increases from 68% to 70% the amount of the net tax proceeds distributed to the counties on a per capita basis, based on the most recent annual population estimates certified by the State Budget Officer.

Streamlined Sales Tax Changes.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-244	**HB 257**	**Representative Hill**

AN ACT TO AMEND THE SALES TAX DEFINITIONS TO COMPLY WITH THE STREAMLINED SALES TAX AGREEMENT AND TO MAKE OTHER SALES TAX CHANGES.

OVERVIEW: This act, which was a recommendation of the Revenue Laws Study Committee, does the following:

- It defines 'bundled transactions' and modifies the definition of 'sales price' to keep North Carolina in compliance with the national Streamlined Sales Tax Agreement.
- Recognizes for-hire boats as commercial fishing operations eligible for the sales tax exemption for items sold for use in commercial fishing.
- Makes conforming and technical changes.

FISCAL IMPACT: Minimal impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective October 1, 2007.

ANALYSIS: This act makes two definitional changes in the sales tax laws to maintain compliance with the latest amendments to the Streamlined Sales and Use Tax Agreement (Agreement). First, it adds a definition of 'bundled transaction' and specifies how these transactions are to be taxed. Second, it modifies the definition of 'sales price' to clarify how third-party discounts, such as a manufacturer's coupon, affect the sales price of an item.

Bundled Transactions

The lack of uniformity among states in the taxation of bundled transactions led to the development of principles of taxation for bundled transactions in the Agreement. A 'bundled transaction' is the sale of an exempt product and a taxable product for one price.[7] It does not include a sale of two or more products whose combined price varies, or is negotiable,

[6] By providing additional funding to the counties directly, the adjustment will also reduce the need for supplemental grants from the Scrap Tire Disposal Account.

[7] Under previous law, the sales price of a bundle of tangible products was taxable. With respect to services, previous law permitted the application of tax to part of the sales price, based on the allocation of revenue to the taxable services in the bundle.

depending on the products a purchaser selects. For tangible products, the bundle is taxable based on the sales price of the bundle unless it meets either the 50% test or the 10% test.

The 50% test applies to bundles of tangible products that include food or medical items that are exempt from State tax. Under the 50% test, if at least 50% of the price of the products in the bundle is attributable to food or medical items that are exempt from State tax, then the bundle is not subject to State sales tax. The bundle is also exempt from local sales tax unless more than 10% of the bundle's price is attributable to food. In this circumstance, the bundle containing food is taxable under the local sales tax at the rate of 2%, which is the rate that applies to food that is not part of a bundle.

The 10% test applies to all other bundles of tangible products. Under the 10% test, if no more than 10% of the price of the products in the bundle is attributable to taxable items, then the bundle is not subject to State or local sales tax.

For services, the bundle is subject to the 10% test, but it can be subject to tax based on the allocated price of the taxable services in the bundle. To be taxed based on part of the sales price, the retailer's accounting records must allocate revenue to the services in the bundle and provide a basis for determining the proportion of the bundle's price that is attributable to each service in the bundle. If the records do not provide for this, the sales price of the bundle is taxable, assuming the taxable services exceed the *de minimus* 10% threshold.

Sales Price

The act amends the definition of 'sales price' to specify when a manufacturer's discount or other discount is considered part of the sales price. Previous law excluded some discounts from the definition of sales price but did not address the subject as fully as the change in the act. A price discount is part of the sales price if the retailer receives reimbursement from a third-party in the amount of the discount. The act does not change the application of the law on this subject.

Commercial Fishing

The act allows the holder of a commercial fishing license, the holder of commercial shellfish license, and the operator of a for-hire boat to qualify for a sales tax exemption for items sold for use in commercial fishing. While for-hire boat operators were not referenced specifically in the prior statute, the administrative practice of the Department of Revenue had been to allow their use of the exemption.

Clarifying and Technical Changes

Section 1 of the act updates the reference to the Streamlined Sales Tax Agreement to June 23, 2007, to include the latest amendments of the Agreement. Section 5 clarifies that anyone who relies on the taxing jurisdiction database developed by the Department to determine the rate of sales tax applicable in a jurisdiction is not liable for any tax underpayments attributable to reliance on that database.[8]

[8] This is the same result as under previous law because the database is a written statement of the Department under G.S. 105-264.

Modify Tax on Property Coverage Contract.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-250	**SB 238**	**Senator Kerr**

AN ACT TO ADJUST THE ADDITIONAL TAX RATE ON PROPERTY COVERAGE CONTRACTS TO BE REVENUE NEUTRAL BASED ON AN EXPANSION OF THE TAX BASE ENACTED IN S.L. 2006-196, TO INCREASE THE DISTRIBUTION OF THE TAX PROCEEDS TO THE VOLUNTEER FIRE DEPARTMENT FUND, TO AMEND THE VOLUNTEER FIRE DEPARTMENT GRANT PROGRAM TO ALLOW MORE DEPARTMENTS TO QUALIFY FOR GRANTS, AND TO MODIFY THE DISTRIBUTION OF TAX PROCEEDS TO THE LOCAL FIREMEN'S RELIEF FUNDS.

OVERVIEW: This act does four things:

- It reduces the additional tax rate applicable to gross premiums on insurance contracts for property coverage from 0.85% to 0.74%, effective January 1, 2008.
- It increases from 20% to 50% the percentage of the tax proceeds derived from the additional fire and lightning tax rate allocated to the Volunteer Fire Department Fund. This change reduces the amount of the tax proceeds allocated to the General Fund.
- It increases the cap on the grants from the Volunteer Fire Department Fund and it changes the qualifications for grants from the Volunteer Fire Department Grant Program to enable more volunteer fire departments to qualify.
- It modifies the distribution of money to the local firemen's relief grant funds so that the distribution more closely resembles the current distribution.

FISCAL IMPACT: The act increases the amount of funds allocable to the Volunteer Fire Department Fund and reduces accordingly the funds credited to the General Fund. The estimated loss to the General Fund, and consequential gain to the Volunteer Fire Department Fund, is $1.49 million for FY07-08 and $3.07 million for FY08-09. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The act became effective January 1, 2008.

ANALYSIS: North Carolina imposes a 1.9% tax rate on the gross premiums of most insurance policies.[9] In addition to the general rate, there is a 1.33% rate applied to the gross premiums on insurance policies that provide fire and lightning coverage. The taxable percentage of the different types of policies varies. Twenty-five percent of the net proceeds

[9] Workers' compensation policies are taxed at 2.5%.

of this additional tax are credited to the Volunteer Fire Department Fund,[10] and the remainder is credited to the General Fund. There is also a 0.5% rate applied to gross premiums on insurance policies that provide fire and lightning coverage within fire districts. The statute authorizing the 0.5% rate does not provide any exceptions from this tax.[11] The net proceeds of this tax are credited to the Department of Insurance and most of the proceeds are distributed to the fire districts.[12]

Last session, in S.L. 2006-196, the General Assembly changed the law, effective January 1, 2008, upon the recommendation of the Revenue Laws Study Committee. The Committee recommended a change in the law because the Department of Revenue informed the Committee that the taxable percentages applied under the previous law were neither statutory nor imposed by administrative rule. S.L. 2006-196 set the percentages for the 2007 taxable year in the statute[13] and it established a new method of taxing insurance policies that provide property coverage effective for taxable years beginning on or after January 1, 2008. Effective 2008, there will be one additional rate applicable to policies covering all types of property damage, not just fire and lightning coverage. The reason for expanding the base to include all types of property coverage is that volunteer fire departments must respond to more than just fire calls; they are often the first responders to many types of calls that involve property damage. To keep the changes revenue neutral, the legislation reduced the tax rate from 1.33% to 0.85%, and it directed the Revenue Laws Study Committee to continue studying this issue to ensure a revenue neutral tax rate.

The base broadening of the 2006 legislation also eliminated the 0.5% tax imposed on contracts of insurance applicable to fire and lightning coverage within fire districts. By applying the tax broadly, it made unnecessary the accounting by insurance companies of the amount of premiums written in fire districts. The removal of this accounting greatly reduces the administrative compliance burden for the companies. The 2006 legislation established a new method of distribution based upon a per capita allocation among fire districts, effective January 1, 2008, and directed the Revenue Laws Study Committee to study the distribution to the local fire districts.

Based upon the recommendation of the Revenue Laws Study Committee to the 2007 General Assembly, this act makes the following changes to the law:

- It reduces the additional tax rate on property coverage contracts from 0.85% to 0.74% to ensure a revenue neutral tax rate. It also clarifies that the tax rate includes wind-only premiums.

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[10] Funds in the Volunteer Fire Department Fund provide matching grants to volunteer fire departments to purchase equipment and make capital improvements. In 2005, the Department received 567 applications for grants requesting matching funds of $6,577,455. The available monies in the Fund totaled only $4,369,976. The Department approved 500 applications totaling $4,365,489.

[11] Prior to January 1, 2008, the 1.33% State rate did not apply to marine and automobile policies.

[12] Three percent (3%) of the tax proceeds are credited to the State Firemen's Association for general purposes. Two percent (2%) of the proceeds are used by the Department of Insurance for the purpose of administering the disbursement. The remaining funds are allocated among the fire districts in proportion to the amount of business done in the district and used by the local district for firemen's local relief purposes. *See Article 84 of Chapter 58 of the General Statutes.*

[13] Fire loss, 100% of policy taxable; homeowners, 50% taxable; farm owners, 30% taxable; non-liability portion of commercial multiple peril, 100%, liability portion of commercial multiple peril, 0%.

- It changes the distribution formula for the funds distributed to local fire districts. The 2006 legislation provided that the funds would be distributed on a per capita basis. Further study revealed that this distribution formula would result in fire districts receiving significantly different distribution amounts. The act changes the distribution formula so that the amounts distributed under it more closely follow the current distribution patterns. Under the new distribution formula, the Insurance Commissioner will allocate to each county the amount of tax proceeds it received in the previous year. From that amount, the Commissioner will distribute to each fire district in the county the amount it received in the previous year. If the amount of proceeds to be allocated varies from the amount allocated the previous year, then the amount allocated to a county will be either reduced or increased by a percentage, the numerator of which is the population of the county and the denominator of which is the population of the State. If the amount to be distributed to the fire districts differs from the amount distributed the previous year, then the amount distributed will be either reduced or increased by a percentage, the numerator of which is the tax value of the property located in the district and the denominator of which is the tax value of all property located in any fire district in that county.
- It increases the percentage of the tax proceeds allocated to the Volunteer Fire Department Fund from 20% to 30%. This change reduces the amount allocated to the General Fund from 55% to 45%.
- It increases from $20,000 to $30,000 the cap on the grants from the Volunteer Fire Department Fund. It also changes in the following ways the qualifications for grants from the Fund so that more volunteer fire departments may qualify for grants:
  - It provides that a volunteer fire department may qualify for a grant if it serves a response area of no more than 12,000 people (was 6,000).
  - It provides that a volunteer fire department may qualify for a grant if it has no more than six full-time paid positions (was three).

Property Tax Commission Terms.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-308	**HB 1555**	**Representative Owens**

AN ACT PROVIDING FOUR-YEAR TERMS FOR ALL APPOINTMENTS TO THE PROPERTY TAX COMMISSION.

OVERVIEW: This act provides that the terms of the members of the Property Tax Commission are for four years and expire on June 30.

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective when signed into law by the Governor on July 28, 2007, and applies to appointments made on or after July 1, 2007.

ANALYSIS: This act provides that all members appointed to the Property Tax Commission will serve four-year terms expiring on June 30. The Property Tax Commission consists of five members, three of whom are appointed by the Governor and two of whom are appointed by the General Assembly. Of the two appointments by the General Assembly, one is made upon the recommendation of the Speaker of the House and the other is made upon the recommendation of the President Pro Tempore of the Senate. Prior to this act, all appointees served four-year terms, except the member appointed upon the recommendation of the Speaker of the House. That member served a two-year term.

The Property Tax Commission is the five-member State board of equalization and review that hears and decides taxpayers' administrative appeals from decisions concerning the listing, appraisal, or assessment of property made by county boards of equalization and review and boards of county commissioners. The Commission also hears appeals from orders of boards of county commissioners adopting schedules of values, standards, and rules. The Commission must meet at least once in each quarter and may hold special meetings at any time and place within the State at the call of the Chair or upon the written request of at least three members. The Chair is designated by the Governor and serves at the pleasure of the Governor. The expenses of the Commission do not come from the General Fund but are paid by local governments.[14] The Commission is authorized to set the salary for its members. Currently, members receive $400 a day for their work on the Commission, and the Chair receives $450 a day.[15]

Conservation Tax Credit Modifications.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-309	**HB 463**	**Representative Luebke**

AN ACT TO MODIFY THE CREDIT FOR CERTAIN REAL PROPERTY DONATIONS.

OVERVIEW: This act does four things:

- It equalizes the cap for the conservation tax credit for corporations and pass-through entities at $500,000.
- It requires a taxpayer claiming the credit to support the claim's represented value of the real property donation.
- It narrows the conservation purposes that qualify property for the credit.

[14] The Department of Revenue collects local sales taxes on behalf of local governments and distributes the proceeds quarterly. In making these distributions, the Department is required under G.S. 105-501 to deduct the State's costs relating to local property tax administration, the Property Tax Commission, the School of Government's property tax training program, and the Local Government Commission.
[15] Section 7.11 of S.L. 2000-67 provides that members receive travel, subsistence, and salary while being trained and clarifies that those members should receive salary and reimbursement while deciding, as well as hearing, cases.

- It provides that a married couple filing jointly is entitled to the same tax credit cap as two unrelated individuals making an equivalent donation of property.

FISCAL IMPACT: There is not sufficient data available for an accurate assessment of the overall fiscal impact from the changes in this act. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The act is effective for taxable years beginning on or after January 1, 2007.

ANALYSIS: The General Assembly first enacted the conservation income tax credit in 1983. The credit is allowed to a taxpayer that donates real property useful for public beach access or use, public access to public waters or trails, fish and wildlife conservation, or other similar land conservation purposes. To qualify for the credit, the land must be donated in perpetuity to and accepted by the State, a local government, or a body organized to receive and administer lands for conservation purposes and qualified to receive charitable contributions. The amount of the credit is 25% of the fair market value of the donated property interest, capped at $250,000 for individuals and $500,000 for corporations.[16]

The Revenue Laws Study Committee reviewed the credit. This act addresses some of the issues identified by the Committee.

Application of dollar limitation. – The act makes two adjustments to the tax credit cap:

- Pass-through entities. – The act equalizes the cap for the conservation tax credit for corporations and pass-through entities at $500,000 by increasing the existing dollar limitation for pass-through entities from $250,000 to $500,000.[17] The higher dollar limitation for a pass-through entity will provide a greater incentive for the multiple owners of a pass-through entity to donate property. Each individual who is an owner of a pass-through entity is allowed a credit equal to the owner's allocated share of the credit to which the pass-through entity is eligible, subject to the individual credit cap of $250,000. When an owner's share of the pass-through entity's credit is limited due to the $250,000 individual credit cap, the pass-through entity and its owners may not reallocate the unused credit among the other owners.

- Married couples. – The act clarifies that the dollar limitation for a married couple filing jointly is $500,000.

The dollar limitation for the initial credit in 1983 was $5,000 for all taxpayers. In 1997, the General Assembly created two different caps: $100,000 for individuals and $250,000 for corporations. In the case of a pass-through entity, the dollar limitation applied to each individual member of the pass-through entity rather than to the pass-through entity itself. The General Assembly increased the dollar limitations to their current amounts in 1999: $250,000 for individuals and $500,000 for corporations.

In 2001, the Revenue Laws Study Committee proposed that North Carolina begin applying dollar amount limitations of most tax credits to pass-through entities as a whole rather than

[16] The higher dollar limitation for corporations reflects the fact that corporations are prohibited from claiming both a tax deduction and a tax credit for the same donation. However, individuals may take a charitable contribution deduction as well as the tax credit for the same donation.
[17] The act makes a technical change to the language of G.S. 105-130.34 to refer specifically to C Corporations, since G.S. 105-151.12 deals with pass-through entities, including S Corporations.

as to each individual member.[18] The bill enacted by the General Assembly, S.L. 2001-335, excluded the conservation tax credit from the general rule found in G.S. 105-269.15 and preserved the historic treatment of pass-through entities taking the tax credit by applying the cap only to the individual members of the pass-through entity. This exception for the conservation tax credit was originally set to expire in 2005; however, the sunset was extended twice, preserving the unique application of the cap for the conservation tax credit until it expired on January 1, 2007. Prior to the enactment of this act, a pass-through entity claiming the conservation tax credit in 2007 would have been limited to a cap of $250,000 and that amount would have been allocable among its owners in proportion to their ownership interest.

Accuracy of valuation. – The act addresses valuation concerns of donated property by requiring the use of certain types of supported appraisal reports or the county's appraisal value. These concerns, reported by the Department of Revenue, stem from the use of restricted appraisal reports that are compiled specifically for one person and contain little or no information relied upon by the appraiser to formulate the property's value and the lack of any requirement under the prior law of specific documentation useful for establishing the fair market value of the donation. Under prior law, a taxpayer was required to file with the income tax return a certification by the Department of Environment and Natural Resources (DENR) that the property is suitable for the statutorily listed conservation purposes. DENR did not review the documentation in an effort to verify the taxpayer's representation as to the fair market value of the donated property interest.

The act addresses this valuation concern by requiring a taxpayer to support a claim for a credit with either a self-contained or a summary appraisal report, which are two types of reports defined by Standards Rule 2-2 of the Uniform Standards of Professional Appraisal Practice and required to have certain information included supporting the valuation determination. A taxpayer may elect, for fee simple donations of property only, to use the county's appraised value of the property as adjusted by the sales assessment ratio.

Clarification of conservation purposes. – The act reduces uncertainty with respect to the types of uses that qualify for conservation purposes by substituting specific uses in place of the catch-all phrase 'other similar land conservation purposes'. Differences in the statutory construction of the phrase, 'other similar land conservation purposes' developed between DENR and the Department of Revenue. The act eliminates the phrase and substitutes six new, specific conservation purposes: forestland or farmland conservation, watershed protection, conservation of natural areas as that term is defined in G.S. 113A-164.3(3), conservation of natural or scenic river areas as those terms are used in G.S. 113A-34, conservation of predominantly natural parkland, or historic landscape conservation.

[18] Doing so brought North Carolina into conformity with how federal law allowed pass-through entities to take tax credits. See G.S. 105-269.15.

2007 Appropriations Act.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-323, as amended by S.L. 2007-345	**HB 1473, as amended by HB 714**	**Rep. Michaux, Crawford, Yongue**

AN ACT TO MAKE BASE BUDGET APPROPRIATIONS FOR CURRENT OPERATIONS OF STATE DEPARTMENTS, INSTITUTIONS, AND AGENCIES, AND FOR OTHER PURPOSES.

OVERVIEW: This act authorizes special indebtedness for various higher education and State facilities, increases various fees to provide revenue necessary to fund receipt-supported services, and makes the following tax law changes:

Section & Effective Dates	Description	Fiscal Impact
Individual & Corporate Income Tax Changes		
31.1 *Effective 1/1/2007*	**IRC Update** – Updates the reference to the Internal Revenue Code to January 1, 2007, which effectively makes the following changes: • Extends the enhanced small business expensing thresholds. • Extends the deduction for higher education expenses. • Extends the deduction for qualified expenses of elementary and secondary school teachers. • Excludes up to $3,000 of otherwise taxable distributions from a government pension plan of retired public safety officers when the money is used to pay for health insurance premiums.	FY 2007-08 $56.9 million loss FY 2008-09 $49.1 million loss FY 2009-10 $14.4 million loss FY 2010-11 $14.1 million loss
31.4 *Effective 1/1/2008* *Expires 1/1/2013*	**Earned Income Tax Credit** – Establishes a refundable State EITC equal to 3.5% of an individual's federal EITC.	FY 2008-09 $48.3 million loss FY 2009-10 $48.3 million loss FY 2010-11 $48.3 million loss FY 2011-12 $48.3 million loss

Section & Effective Dates	Description	Fiscal Impact
31.5 *Effective 1/1/2007* *Expires 1/1/2013*	**Reenact Long-Term Care Credit** - Subject to an income limitation, allows a taxpayer to receive a credit equal to 15% of the premium paid each year on a long-term care insurance policy, with a cap of $350 per policy. The prior credit expired in 2004.	FY 2007-08 $7.0 million loss FY 2008-09 $7.2 million loss FY 2009-10 $7.3 million loss FY 2010-11 $7.5 million loss FY 2011-12 $7.7 million loss
31.6 *Effective 1/1/2007* *Expires 1/1/2013*	**Adoption Tax Credit** – Establishes a nonrefundable credit for adoption-related expenses equal to 50% of the federal adoption credit amount. The amount is reduced based upon a taxpayer's modified AGI.	FY 2007-08 $3.0 million loss FY 2008-09 $3.0 million loss FY 2009-10 $3.0 million loss FY 2010-11 $3.0 million loss FY 2011-12 $3.0 million loss
31.18 *Effective 1/1/2007*	**REIT Provision** - Limits a corporation's ability to use captive real estate investment trusts (REITs) to avoid State taxes by disallowing the dividend paid deduction when a REIT is a captive REIT.	No discernable impact.
31.19 *Effective 1/1/2007*	**Enhance 529 Plan Income Tax Deduction** -Changes the current income tax deduction for contributions to the Parental Savings Trust Fund as follows: • It removes the January 1, 2011 sunset. • It increases the maximum annual deduction amount allowable from $2,000 to $2,500 single filers and from $4,000 to $5,000 for married couples filing jointly. • It removes the income limitations for taxable years 2007 through 2011.	FY 2007-08 $0.2 million loss FY 2008-09 $0.2 million loss FY 2009-10 $0.2 million loss FY 2010-11 $0.2 million loss FY 2011-12 $0.2 million loss
31.21 *Effective 1/1/2007*	**Work Opportunity Tax Credit** – Establishes an income tax credit for a taxpayer who is allowed a Work Opportunity Tax Credit (WOTC) under the IRC. The amount of the credit is equal to 6% of the amount of credit allowed under the Code. The credit allowed may not exceed 50% of the tax against which it is claimed, and any unused portion of the credit may be carried forward for five years.	FY 2007-08 $3.0 million loss FY 2008-09 $3.0 million loss FY 2009-10 $3.0 million loss FY 2010-11 $3.0 million loss FY 2011-12 $3.0 million loss

Section & Effective Dates	Description	Fiscal Impact
31.24 *Effective 1/1/2007*	**Firefighter/Rescue Squad Tax Deduction** – Establishes a $250 income tax deduction for a person who works as an unpaid member for a volunteer fire department, volunteer rescue department, or an EMS squad and attends at least 36 hours of training during the year.	FY 2007-08 $10.5 million loss FY 2008-09 $10.7million loss FY 2009-10 $10.8 million loss FY 2010-11 $11.0 million loss FY 2011-12 $11.2 million loss
Effective 1/1/2008	**Expiration of Upper Income Tax Bracket**[19] **–** Under current law, the upper income tax rate is 8% for tax year 2007. This rate is scheduled to be eliminated in 2008. As part of its overall budget package, the General Assembly decided not to extend the sunset. Thus, the current 8% upper income tax bracket will expire in 2008. Beginning with tax year 2008, the top rate will be 7.75%.	The fiscal impact of this item is considered to be zero since it is allowing a tax to sunset.
Sales Tax Changes		
31.2 *Effective 7/31/2007*	**Maintain Current Sales Tax Rate** – Makes permanent the State sales tax rate at 4.25%.	FY 2007-08 $258.4 million gain FY 2008-09 $285.9 million gain FY 2009-10 $299.2 million gain FY 2010-11 $312.6 million gain FY 2011-12 $326.7 million gain
31.14 *Effective 10/1/2007*	**Amend Sales Tax Holiday –** Provides that school instructional materials with a sales price of $300 or less are exempt from sales tax during the first weekend of August.	

[19] There was no legislative action taken during the 2007 Session to effectuate this change.

Section & Effective Dates	Description	Fiscal Impact
Economic Incentives		
31.7 *Effective 10/1/2007*	**Privilege Tax on Software Publishers' Machinery & Equipment** – Reduces the tax paid on certain purchases of machinery and equipment by software publishing companies by exempting those purchases from the 6.75% sales tax and imposing a 1% privilege tax on the sales prices, subject to an $80 cap.	FY 2007-08 $2.8 million loss FY 2008-09 $4.0 million loss FY 2009-10 $4.0 million loss FY 2010-11 $4.0 million loss FY 2011-12 $4.1 million loss
31.8 *Effective 1/1/2007*	**Enhance Tax Credit for R & D Expenditures** – Expands the existing tax credit for taxpayers with qualified research and development expenses. The amount of the credit is equal to a percentage of the qualifying expenses and varies depending upon the size and tier location of the business.	FY 2007-08 $0.4 million loss FY 2008-09 $0.8 million loss FY 2009-10 $1.2 million loss FY 2010-11 $1.2 million loss FY 2011-12 $1.2 million loss
31.9 *Effective 1/1/2007*	**Modify Tax Credit for Constructing Renewable Fuel Facilities** – Modifies the enhanced credit for constructing renewable fuel production facilities as follows: • The credit may be claimed against the franchise tax as well as the income tax. • A taxpayer who claimed the enhanced tax credit and later fails to meet the requirements of the enhanced credit may take the non-enhanced credit for constructing renewable fuel production facilities. A taxpayer who forfeits the enhanced credit must pay the additional avoided taxes and interest on the avoided taxes from the original due date of the taxes.	FY 2007-08 No impact FY 2008-09 $2.3 million loss FY 2009-10 $4.8 million loss FY 2010-11 $6.8 million loss FY 2011-12 $6.8 million loss

Section & Effective Dates	Description	Fiscal Impact
31.10 *Effective 7/31/2007*	**Expand Sales and Use Tax Refund for Certain Aircraft Manufacturers** – Expands the definition of 'aircraft manufacturing' and allows aircraft manufacturers to qualify for a refund of sales and use taxes paid on building materials and supplies, fixtures, and equipment that are installed in the construction of and become part of the real property of the aircraft manufacturing industrial facility. The taxpayer must meet minimum investment thresholds to qualify.	FY 2007-08 $0.8 million loss FY 2008-09 $0.8 million loss FY 2009-10 $0.8 million loss FY 2010-11 $0.8 million loss FY 2011-12 $0.8 million loss
31.20 *Effective 7/31/2007*	**Sales Tax Refund – Research Supplies** – Provides a sales and use tax refund to a taxpayer who is engaged in analytical services in the State. The amount of the refund depends upon the amount by which the tax paid in the fiscal year exceeds the amount paid in fiscal year 06-07.	FY 2007-08 No impact FY 2008-09 $2.6 million loss FY 2009-10 $5.4 million loss FY 2010-11 $5.7 million loss FY 2011-12 $6.0 million loss
31.22 *Effective 10/1/2007*	**Datacenter Sales Tax Exemption** – Reduces the tax paid on certain purchases of machinery and equipment located and used at eligible datacenters by exempting the purchases from the 6.75% sales tax and imposing a 1% privilege tax on the sales price, subject to an $80 cap.	FY 2007-08 No impact FY 2008-09 No impact FY 2009-10 $5.2 million loss FY 2010-11 $7.0 million loss FY 2011-12 $8.7 million loss
31.23 *Effective 1/1/2007*	**Tax Incentive for Railroad Intermodal Facility** – Establishes a new income tax credit and new sales and use tax exemptions and refunds for a taxpayer who constructs or leases and puts into operation an eligible railroad intermodal facility. To be eligible, the cost of construction of the facility must exceed $30 million.	FY 2007-08 $0.2 million loss FY 2008-09 $0.3 million loss FY 2009-10 $0.9 million loss FY 2010-11 $2.0 million loss FY 2011-12 $2.0 million loss
Excise Taxes		
6.23 *Effective 10/1/2007*	**University Cancer Research Fund** – Increases from 3% to 10% the excise tax on OTP to fund, in part, the University Cancer Research Fund.	FY 2007-08 $11.4 million gain FY 2008-09 $16.5 million gain FY 2009-10 $17.0 million gain FY 2010-11 $17.5 million gain FY 2011-12 $18.1 million gain

Section & Effective Dates	Description	Fiscal Impact
31.15 *Effective 7/31/2007*	**Cap the Variable Wholesale Component of the Motor Fuels Tax Rate for Two Years** – Extends the existing cap for two years, capping the variable wholesale component of the motor fuels tax rate at 12.4¢ per gallon for the period July 1, 2007, through June 30, 2009, for a maximum possible rate of 29.9¢ per gallon.	FY 2007-08 $85.8 million loss FY 2008-09 $54.3 million loss
General State & Local Changes		
31.16 *Effective over 3-year period, beginning 10/1/2007*	**State Assume Medicaid Responsibilities** – Provides that the State assumes the counties' share of the nonfederal share of Medicaid costs over a three-year period as set out below. To offset the cost to the General Fund, the third one-half cent local sales tax is phased out and the State sales tax rate is increased by the same amount. 10/1/2007 = 25% 7/1/2008 = 50% 7/1/2009 = 100%	FY 2007-08 $60.8 million loss FY 2008-09 $91.9 million loss FY 2009-10 $146.7 million loss FY 2010-11 $149.5 million loss FY 2011-12 $184.1 million loss
31.17 *Effective 7/31/2007*	**Local Option County Taxes** – Provides authority for two new local taxes, of which counties may choose to levy only one if a majority of those voting in a referendum vote for the levy of the tax: • Land transfer tax on transfers of land within the county. The rate of tax may be up to .4% of the greater of the value of or consideration paid for the property, and the rate must be an increment of .1%. • A ¼-cent sales and use tax. The rate of tax is .25% of the sales price of the item, in addition to all other State and local sales and use taxes, except for purchases of food exempt from tax under G.S. 105-164.13B. The adoption, levy, collection, administration, and repeal of this sales and use tax are in accordance with the first one-cent local sales and use tax.	No State impact.

<u>FISCAL IMPACT:</u> See **<u>ANALYSIS</u>**. *(For a more complete fiscal analysis, see Overview: <u>Fiscal and Budgetary Actions</u>, 2007 Session. Available in the Legislative Library.)*

<u>EFFECTIVE DATE:</u> See **<u>ANALYSIS.</u>**

<u>ANALYSIS:</u> The 2007 Appropriations Act made many tax law changes and appropriated funds to be used for economic development, authorized special indebtedness for various higher education and State facilities, and increased various fees to provide revenue necessary to fund receipt-supported services.

Part I: Individual and Corporate Income Tax Changes

<u>IRC update.</u> – Section 31.1 of the act updates the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from January 1, 2006, to January 1, 2007. The section became effective when the Governor signed the act into law on July 31, 2007. The provision is a recommendation of the Revenue Laws Study Committee and was included in the Governor's revenue recommendations. Fiscal Research estimates that conforming to the Code will reduce General Fund availability by $56,900,000 in FY07-08 and by $49,100,000 in FY08-09. Updating the reference to the Code effectively made the following tax policy changes:

- It extends the enhanced small business expensing thresholds.
- It extends the deduction for higher education expenses.
- It extends the deduction for qualified expenses of elementary and secondary school teachers.
- It authorizes the exclusion of up to $3,000 of otherwise taxable distributions from a government pension plan of retired public safety officers when the money is used to pay for health insurance premiums.

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code. The General Assembly determines each year whether to update its reference to the Internal Revenue Code. Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Changing the reference date to January 1, 2007, incorporates the changes made in the following acts: the Deficit Reduction Act of 2005, the Tax Increase Prevention and Reconciliation act of 2005, the Heroes Earned Retirement Opportunities Act, the Pension Protection Act of 2006, and the Tax Relief and Health Care Act of 2006.[20]

<u>Earned income tax credit.</u> – Section 31.4 of the act establishes a refundable State earned income tax credit.[21] The credit is equal to 3.5% of an individual's federal earned income tax credit. It becomes effective for taxable years beginning on or after January 1, 2008, and expires for

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[20] A more detailed summary of the recent amendments to the Code is available upon request.

[21] As of 2006, 20 states offer an earned income tax credit. In most instances, the credit is refundable. North Carolina has three other refundable tax credits: the credit for qualifying expenses of a production company, the credit for low-income housing, and the credit for reinvestment by major recycling facilities.

taxable years beginning on or after January 1, 2013. Fiscal Research estimates that the earned income tax credit will reduce General Fund availability by $48,300,000 in FY08-09.

The Internal Revenue Code provides an earned income tax credit for individuals who work and whose adjusted gross income does not exceed a specified amount. The credit is intended to offset some of the increases in living expenses and social security taxes and provide an incentive for low-income families to work instead of collect welfare. The amount of the credit may exceed the amount of tax owed by the taxpayer. If the credit allowed exceeds the amount of tax imposed, the excess is refundable to the taxpayer.

To be eligible for the credit, an individual must meet the following requirements:

- Have a valid social security number.
- Have earned income from employment or self-employment.
- Be a U.S. citizen, a resident alien all year, or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return.
- Is not a qualifying child of another person.
- Have a qualifying child OR meet the following requirements:
  - Age 25 but under age 65 at the end of the year.
  - Live in the U.S. for more than half the year.

The amount of the federal credit varies depending upon whether the taxpayer has children and the amount of earned income the taxpayer has. The credit is phased out as the taxpayer's earned income rises. To qualify for the credit in 2006, an individual's earned income may not exceed $38,348 for an individual who is married filing jointly with two or more qualifying children. The maximum federal credit amount allowed in 2006 is $4,536 for an individual with two or more qualifying children; for North Carolina, the maximum credit amount would be approximately $159. The maximum federal credit amount in 2006 for an individual with no children is $412; for North Carolina the maximum credit amount would be approximately $14. The earned income amounts and the credit amounts are indexed to inflation.

In the 2005 tax year, more than 22 million individuals received $41.4 billion in the federal earned income tax credit. However, the IRS estimates that 20 to 25% of people who qualify for the credit do not claim it. To better ensure taxpayers in North Carolina receive the benefits of the earned income tax credit, Section 24.3 of this act, as amended by Section 14.3 of S.L. 2007-345 (Section 14.3 of HB 714) [22] does two things:

- It requires the Department of Revenue to include information on the earned income tax credit in its printed booklets for the individual income tax return.
- It requests that software companies producing computer programs for tax calculation in North Carolina design the programs to automatically compute an individual's eligibility for the State and federal credit.

Reenact long-term care credit. – Long-term care insurance is designed to protect individuals against the high costs of long-term care. The General Assembly enacted a long-term care

[22] Section 14.3 of S.L. 2007-345 changes the effective date of this administrative provision from January 1, 2007, to January 1, 2008 to conform to the effective date of the new State earned income tax credit.

insurance tax credit in 1998. It expired in 2004.[23] Section 31.5 of this act reenacts the individual income tax credit for premiums paid on long-term care insurance, effective for taxable years beginning on or after January 1, 2007. The credit expires for taxable years beginning on or after January 1, 2013. Fiscal Research estimates that the credit will reduce General Fund revenues by $7,000,000 in FY07-08 and by $7,200,000 in FY08-09.

The credit amount is equal to 15% of the premium paid each year on a long-term care insurance policy. The credit may not exceed $350 for each policy for which the credit is claimed. The credit differs from the former credit in that to be eligible to claim it a taxpayer's adjusted gross income must not exceed the following amount:

Filing Status	AGI
Married filing jointly	$100,000
Head of Household	$ 80,000
Single	$ 60,000
Married filing separately	$ 50,000

A taxpayer may claim a credit for policies that provide coverage for either the taxpayer, the taxpayer's spouse, or a family member for whom the taxpayer provides over half of the support and whose income is below an exemption amount. The credit may not exceed the amount of tax owed by the taxpayer, and there is no provision to allow unused portions of the credit to be carried forward.

Under federal law, premiums paid on long-term care insurance contracts are treated as deductible medical expenses. Under the medical expense itemized deduction, unreimbursed medical expenses may be deducted to the extent that the expenses exceed 7.5% of adjusted gross income. To the extent a taxpayer will receive a deduction for long-term care insurance premiums under the Code, the taxpayer will receive a deduction for State income tax purposes as well since North Carolina uses federal taxable income as the starting point for calculating State taxable income. To prevent a double tax benefit in those cases, the credit is limited to those expenses for which a deduction has not been claimed.

Since 2003, bills to reinstate the credit have been introduced, but until this act, those bills were not enacted. In S.L. 2006-66, the General Assembly directed the Department of Health and Human Services to develop a North Carolina Long-Term Care Partnership Program as an alternative to the tax credit to encourage people to purchase long-term care insurance. This program is a joint effort between states and private insurance companies with a goal of reducing Medicaid expenditures. The Program allows those that purchase long-term care insurance policies to protect some or all of their assets and still qualify for Medicaid. This Program remains in effect.

Adoption tax credit. – Section 31.6 of this act creates an individual income tax credit for adoption related expenses. The amount of the credit is equal to 50% of the taxpayer's federal adoption tax credit amount. The federal adoption tax credit amount may be up to $10,960 per eligible child for the 2006 taxable year. The amount of the credit is reduced based upon the taxpayer's modified adjusted gross income. For the 2006 taxable year, the tax credit

[23] The Department of Revenue reported in 2001 that 90% of the taxpayers who claimed the credit were not eligible for it. The error rate declined to 27% in 2002 and to 15% in 2003.

phase-out ranges from $164,410 to $204,410. Both the credit amount and the income phase-out ranges are indexed to inflation. The credit may not exceed the amount of tax owed by the taxpayer. However, like the federal tax credit, the State tax credit may be carried forward for five years. The credit is effective for taxable years beginning on or after January 1, 2007, and expires for taxable years beginning on or after January 1, 2013. The Governor included this provision in his budget recommendations. Fiscal Research estimates that the credit will reduce General Fund availability by $3,000,000 in FY07-08 and in FY08-09.

To be eligible for the federal adoption tax credit, a taxpayer must adopt an eligible child and pay qualified adoption expenses. An eligible child is a child 17 years of age or younger or a child of any age who is a U.S. citizen or resident alien and who is physically or mentally incapable of caring for himself or herself. Qualified adoption expenses are calculated by adding up all the expenses directly related to the adoption that are reasonable and necessary for the adoption and subtracting any amounts reimbursed or paid for by an employer, government agency, or other organization. Taxpayers who adopt a special needs child may claim the full amount of the credit without regard to the actual expenses paid.

The year in which a taxpayer may claim the credit depends on when the adoption was finalized and whether the adopted child is a U.S. citizen, resident alien, or a foreign national. If the child is a U.S. citizen or a resident alien, the adoption credit may be claimed for expenses incurred before the adoption is final in the year after the expenses are incurred; it may be claimed in the same year for expenses incurred in the year the adoption is final; and it may be claimed in the year the expenses are incurred if they are incurred in the year after the adoption is final. For a child who is a foreign national, the credit may be claimed in the year the adoption becomes final, or in the year the expenses are incurred if they are incurred in the year after the adoption becomes final. The dollar limit for a particular year must be reduced by the amount of qualifying expenses taken into account in previous years for the same adoption effort.

Alternative for addressing a corporation's attempt to avoid State taxes through the use of a REIT. – Section 31.18 of this act limits a corporation's ability to use captive real estate investment trusts (REITs) to avoid State taxes by disallowing the dividend paid deduction when a REIT is a captive REIT. A REIT is an organization that uses the pooled capital of many investors to purchase and mange real estate. A REIT that is owned or controlled by a single entity is commonly referred to as a captive REIT. Two common types of captive REITs are rental REITs and mortgage REITs.

Under federal and State law, a REIT is taxable only on income that is not distributed to shareholders. The amount of income a REIT distributes is not subject to tax because the REIT is allowed a deduction for the dividends it pays. The amounts received by the shareholders of the REIT are taxable.

In a rental REIT, a corporation that owns real property and uses the property in its business, such as a retail store, forms a REIT and transfers ownership of the property to the REIT. The corporation that operates the store and uses the property makes rental payments to the REIT, which reduces the State income tax liability of the corporation. The REIT is not taxed on the rental income because it is allowed a dividend paid deduction under federal law.

If the corporation receives dividends from the REIT directly, the corporation will pay tax on the dividends it receives. If, however, an affiliated corporation receives the dividends from the REIT and then transfers the dividends to the corporation, the corporation will not pay tax on the amount it receives because it will be able to deduct the amount received from the affiliated corporation under another deduction allowed under federal and state law — the dividend received deduction. If the affiliated company that receives the dividends from the captive REIT is outside the State and has no nexus with the State, the out-of-state holding company will pay no State tax on the income.

As a result of this chain of transfers, the corporation is allowed a deduction for rental expenses, the REIT that receives the rental income is allowed a dividend paid deduction when it distributes the rental income, the out-of-state affiliate that receives the dividend from the REIT is not subject to tax in North Carolina (because of lack of nexus), and the corporation that receives the dividend from its affiliated out-of-state holding company is not subject to tax on the amount it receives because of the dividend received deduction. The corporation has, in effect, been allowed a deduction for its rental expenses and been able to receive the amount it deducted as tax-free income in the form of a dividend received.

In a mortgage REIT, a financial institution forms a REIT and transfers to the captive REIT mortgages or mortgage-backed securities originated by the financial institution. The interest income that would have accrued to the financial institution now accrues to the REIT. The REIT takes the dividend paid deduction when it distributes its income.

The Department of Revenue is aggressively pursuing the closure of this tax avoidance strategy. The Secretary of Revenue has the statutory authority to require a corporate taxpayer to file a consolidated return if the Secretary finds that a separate return filed by the taxpayer does not disclose the true earnings on its business carried on in this State. The Secretary also has the authority to determine the net income of a corporate taxpayer properly attributable to this State if the Secretary has reason to believe the taxpayer's report does not do so. In most instances, this method of addressing a corporation's attempt to use a captive REIT to shift income between entities and avoid State taxes is arduous and litigious.

Section 31.18 of this act provides another method to prevent this tax avoidance strategy. Effective for taxable years beginning on or after January 1, 2007, a captive REIT is not allowed to take the dividend paid deduction under State law.[24] Instead, the captive REIT is subject to tax on those dividends and the entity that received the dividend from a captive REIT is allowed a dividend received deduction so that the dividend is not taxed twice.

A 'captive REIT' is defined as a REIT whose shares or certificates of beneficial interest are not regularly traded on an established securities market and are owned or controlled, at any time during the last half of the tax year, by a person that is subject to tax under this Part and is not one of the following:

- A REIT.
- A listed Australian property trust. A listed Australian property trust is Australia's version of a U.S. publicly traded REIT.

This section also directs the Department of Revenue to report to the Revenue Laws Study Committee by May 1, 2009, on the amount of corporate income tax revenue generated by closing the captive REIT loophole. Based upon this report, the Revenue Laws Study

[24] Several states have enacted captive REIT legislation similar to these provisions. The states are: Maryland (HB 1257 of the 2007 Session), Kentucky, Indiana, Pennsylvania, Louisiana, and Mississippi.

Committee must determine the revenue-neutral corporate income tax rate and include this information in its report to the 2010 Session of the 2009 General Assembly.

Enhance 529 Plan income tax deduction. – Section 31.19 of this act makes the following three changes to the income tax deduction for contributions made to the Parental Savings Trust Fund, created by the General Assembly last session in S.L. 2006-66:

- It removes the January 1, 2011 sunset of the deduction.
- It increases the maximum annual deduction amount allowable to an individual taxpayer for contributions to the Parental Savings Trust Fund from $2,000 to $2,500. In the case of a married couple filing a joint return, it increases the maximum deduction amount from $4,000 to $5,000.
- It removes the income limitations for taxable years 2007 through 2011.

The changes become effective for taxable years beginning on or after January 1, 2007. Fiscal Research estimates that the changes will reduce General Fund availability by $200,000 for FY07-08 and FY08-09.

In 1996, the General Assembly established the Parental Savings Trust Fund. The Fund is maintained by the State Education Assistance Authority, a political subdivision of the State, and is administered by the College Foundation of North Carolina as agent of the Authority. The Fund was established to enable qualified parents to save funds to meet the costs of the postsecondary education expenses of eligible students. Anyone may contribute to the Fund. Because the Fund meets the qualifications of a qualified tuition program under Section 529 of the Internal Revenue Code, distributions from the Fund are excludable from taxable income to the extent the distributions are used to pay for qualified higher education expenses. Interest earned on the Fund is also tax-exempt.

Every state offers a state Section 529 plan, and at least twenty-five states allow for a full or partial income tax deduction for contributions to the state's own plan. Last session, effective for the 2006 taxable year, the General Assembly enacted legislation that allows an individual taxpayer to deduct from the taxpayer's taxable income an amount contributed by a taxpayer to an account in the State's plan: the Parental Savings Trust Fund. The maximum amount that may be deducted by an individual in the 2006 taxable year was $750; the maximum amount for a married couple filing jointly was $1,500. The maximum deductible amount for the 2007 taxable year was $2,000 for an individual taxpayer and $4,000 for a married couple filing jointly. This act increases the amounts deductible for taxable years beginning on or after January 1, 2007, by $500 to $2,500 and $5,000 respectively.

To qualify for the deduction, the adjusted gross income of the individual taxpayer or married couple filing jointly may not exceed the stated statutory amount. The income limitations of the deduction are the same income limitations a taxpayer must meet to qualify for the higher personal exemption amount and the $75 tax credit for each dependent child. This act removes the income limitation for five years: taxable years 2007 through 2011. Effective for taxable years beginning on or after January 1, 2012, an individual will not qualify for the State tax credit unless the individual's adjusted gross income falls below the statutory limitations.

The Parental Savings Trust Fund deduction must be added back to taxable income if the amount withdrawn from the Fund was not used to pay for qualified higher education expenses of the designated beneficiary. An exception is made if the withdrawal was made due to the death or permanent disability of the beneficiary.

Work Opportunity Tax Credit. – Section 31.21 of this act provides a State income tax credit to a taxpayer who is allowed a Work Opportunity tax credit (WOTC) under the Internal Revenue Code. The amount of the credit is equal to 6% of the amount of credit allowed under the Code. The credit may be claimed against the franchise tax or the income tax. The taxpayer must elect the tax against which a credit will be claimed when filing the return; the election is binding. The credit allowed may not exceed 50% of the tax against which it is claimed. Any unused portion of the credit may be carried forward for five years. The carryforwards must be claimed against the same tax. The credit is effective for taxable years beginning on or after January 1, 2007. The federal credit expires December 31, 2007. Fiscal Research estimates that the credit will reduce General Fund availability by $3,000,000 for FY07-08 and FY08-09.

The WOTC is designed to help move people from welfare into gainful employment and obtain on-the-job experience. On December 20, 2006, the President signed into law the Tax-Relief and Health Care Act of 2006 (P.L. 109-432). This legislation merged the Welfare-to-Work Tax Credit into the WOTC and extended the WOTC program for a two-year period, through December 31, 2007. The current credit applies only to new employees hired on or after January 1, 2007, and before January 1, 2008. The new employee must belong to one of the following nine target groups:

- A member of a family that is receiving or recently received Temporary Assistance to Needy Families (TANF) for at least 18 consecutive months ending on the hiring date.
- A member of a family that is receiving or recently received TANF benefits for any 9-month period during the 18-month period ending on the hiring date.
- An 18 to 39 year old member of a family that is receiving or recently received food stamps.
- An 18 to 24 year old resident of one of the federally designated Empowerment Zones (EZ), Enterprise Communities (EC), or Renewal Communities (RC).
- A 16 to 17 year old EZ/EC/RC resident hired between May 1 and September 15 as a Summer Youth Employee.
- A veteran who is a member of a family that is receiving or recently received food stamps.
- A Vocational Rehabilitation Referral who completed or is completing rehabilitation services from a State certified agency, an Employment Network, or the U.S. Department of Veterans Affairs.
- An ex-felon who has been convicted of a felony and has a hiring date which is not more than one year after the last date on which he was so convicted or released from prison.
- A recipient of Supplemental Security Income benefits.

A new adult employee must work a minimum of 120 or 400 hours and individuals hired as Summer Youth employees must work at least 90 days, between May 1 and September 15, before an employer is eligible to claim the credit. The credit may be as much as $2,400 for each new adult hire, $1,200 for each new Summer Youth hire, and $9,000 for each new long-term family assistance recipient hired over a two-year period. To claim the credit, an employer must seek and receive certification from the IRS that the new employee qualifies the employer for the tax credit.

Firefighter/Rescue Squad Deduction. – Section 31.24 of this act creates a State income tax deduction for an individual who meets all three of the following conditions:

- Works as an unpaid member,
- For a volunteer fire department, a volunteer rescue squad, or an emergency medical services squad,
- And attends 36 hours of training during the taxable year.

The amount of the deduction is $250. An individual may only claim one deduction in a single taxable year.[25] In the case of a married couple filing a joint return, each spouse must qualify separately for the deduction. The deduction is effective for taxable years beginning on or after January 1, 2007. There is no sunset on the deduction. Fiscal Research estimates that the deduction will reduce General Fund availability by $1,000,000 in FY07-08 and in FY08-09.

Expiration of Upper Income Tax Bracket. – In 2001, the General Assembly created a fourth income tax bracket that imposed an additional ½-percent income tax (a total rate of 8.25%) on certain North Carolina taxable income for three years. The change was estimated to affect approximately 2% of North Carolina taxpayers. In 2003, the General Assembly extended the tax rate for two years. In 2005, the General Assembly extended the tax rate for an additional two years. In 2006, the General Assembly reduced the top individual income tax rate by ¼ percent a year earlier than required by law. Thus, the upper income tax rate is 8% for tax year 2007. This rate is scheduled to be eliminated in 2008. While the Governor proposed extending the upper rate for an additional two years, the General Assembly took no legislative action on this issue during the 2007 session, effectively allowing the current 8% upper income tax bracket to expire. Beginning with the 2008 tax year, the top rate will be 7.75%.

Part II: Sales Tax Changes

Maintain Current Sales Tax Rate. – Section 31.2 of this act maintains the current sales tax rate at 4.25%. Prior to October 16, 2001, the general rate of State sales tax was 4%. Effective October 16, 2001, the general rate was raised to 4.5%. The increase was to sunset July 1, 2003. S.L. 2003-284 extended the sunset for two years to July 1, 2005. S.L. 2005-276 extended the sunset an additional two years to July 1, 2007. S.L. 2006-66 reduced the rate by ¼ cent earlier than was required under S.L. 2005-276 so that the State sales tax rate became 4.25%, effective December 1, 2006. S.L. 2007-145 extended the sunset of the remaining ¼ cent additional State sales tax rate from July 1, 2007, to August 1, 2007. This section eliminates the scheduled reduction, making the 4.25% State sales tax rate permanent. The change became effective when the Governor signed the act into law on July 31, 2007.

Amend Sales Tax Holiday. – Section 31.14 of this act makes substantive and conforming changes to enhance the sales tax holiday for school instructional material. The act does this

[25] An individual may not claim a deduction as both a firefighter and a rescue squad worker in a single taxable year.

by separating 'school instructional material' from 'school supply'. School instructional material is defined in accordance with the Streamlined Sales and Use Tax Agreement as: 'written material commonly used by a student in a course of study as a reference and to learn the subject being taught'. Practically speaking, the term encompasses primarily textbooks and workbooks. Under prior law, school instructional materials were exempt from sales tax if they had a sales price of $100 or less per item. This section expands that exemption to include any item of school instructional material with a sales price of $300 or less per item. This section became effective October 1, 2007, and applies to sales made on or after that date.

Part III: Economic Incentives

One North Carolina Fund. – The act appropriates $14 million to the One North Carolina Fund, administered by the Department of Commerce. These funds are used to offer economic development incentive grants to businesses creating new jobs in the State for infrastructure, repair and renovation, and machine or equipment purchases.

Temporary expansion of JDIG cap. – Section 13.1A of the act temporarily increases from $15 million to $25 million the maximum amount of total annual liability that may be incurred under the Job Development Investment Grant Program for 2007.

Privilege tax on software publishers' machinery and equipment. – Section 31.7 of this act subjects certain purchases of machinery and equipment by software publishing companies to a privilege tax under Article 5F of Chapter 105 of the General Statutes and exempts those purchases from sales tax. The amount of the privilege tax is 1% of the sales price of each article of machinery and equipment, limited to $80 per article. To qualify for the preferential tax rate, the following conditions must be met: (1) the purchase must be by a software publishing company in industry group 5112 of NAICS, and (2) the purchase must be of equipment or an attachment or repair part for equipment that is capitalized by the company for tax purposes under the Code, that is used by the company for research and development of tangible personal property, and that would be considered mill machinery under G.S. 105-187.51. This section became effective October 1, 2007, and applies to sales occurring on or after that date.

Enhance tax credit for research and development expenditures. – Section 31.8 of this act expands the existing tax credit for taxpayers with qualified research and development expenses. In order to be eligible for the credit, the taxpayer must satisfy the wage standard, health insurance, environmental impact, and safety and health record requirements under Article 3J. The amount of the credit is equal to a percentage of the qualifying expenses. For small business taxpayers, the applicable percentage is increased from 3% to 3.25% of the qualifying expenses. For expenses with respect to research performed in a development tier one area, the applicable percentage is increased from 3% to 3.25% of the qualifying expenses. For expenses other than those incurred by small business taxpayers or incurred for research performed in a development tier one area, the applicable percentage (i) for expenses up to $50 million is increased from 1% to 1.25% of the qualifying expenses (ii) for expenses over $50 million and up to $200 million is increased from 2% to 2.25% of the qualifying expenses, and (iii) for expenses over $200 million is increased from 3% to 3.25% of the qualifying expenses. Finally, for North Carolina university research expenses, the applicable percentage is increased from 15% to 20% of the qualifying expenses. For each expense, only one credit is allowed; therefore, if an expense qualifies under more than one subdivision and for more than one percentage, only the higher percentage for that expense is allowed. This section is effective for taxable years beginning on or after January 1, 2007.

Modify tax credit for constructing renewable fuel facilities. – In 2004, the General Assembly created a credit for constructing renewable fuel production facilities. The credit is equal to 25% of the costs of constructing the facility. The credit may be claimed against income tax or franchise tax, is limited to 50% of the amount of tax liability against which it is claimed, and has a carryforward period of five years. That credit was set to sunset for taxable years beginning on or after January 1, 2008. In 2006, the General Assembly modified the credit by extending the sunset until 2011 and by creating an enhanced credit if the taxpayer invests at least $400 million in three separate facilities over a five-year period. As with the existing credit, the enhanced credit cannot exceed 50% of the amount of tax liability. Unlike the existing credit, the enhanced credit is equal to 35% of the costs of constructing the facility and may be claimed only against the income tax with a carryforward period of 10 years. A taxpayer may not claim both credits with respect to the same facility.

Section 31.9 of the act modifies the enhanced credit in two ways. First, the credit may be claimed against income tax or franchise tax. Second, a taxpayer who claimed the enhanced tax credit and later fails to meet the requirements of the enhanced credit may take the non-enhanced credit for constructing renewable fuel production facilities. A taxpayer who forfeits the enhanced credit must pay the additional avoided taxes and interest on the avoided taxes from the original due date of the taxes. Taxpayers have 30 days after the date the taxpayer no longer qualifies for the enhanced credit to pay the additional taxes, otherwise the total amount is subject to the penalties provided in G.S. 105-236. The modifications to the tax credit become effective for taxable years beginning on or after January 1, 2007.

Expand Sales and Use Tax Refund for Certain Aircraft Manufacturers. – Section 31.10 of this act expands the sales and use tax refund for qualifying aircraft manufacturers. This section became effective July 1, 2007, and applies to purchases made on or after that date.

The owner of an aircraft manufacturing industrial facility is allowed an annual refund of sales and use taxes paid, including those indirectly incurred, on qualified building materials and supplies, fixtures, and equipment that are installed in the construction of and become part of the real property of the facility. A written request for a refund is due within six months of the end of the State's fiscal year.

An aircraft manufacturing industrial facility is eligible for the refund if the Secretary of Commerce has certified that the owner of the facility will invest, in the construction of a facility located within the State. The taxpayer must invest at least $50 million for facilities located in development tier one areas or at least $100 million for all other facilities.

Under prior law, an aircraft manufacturing industry that qualified for the refund was limited to manufacturing or assembling complete aircraft. This section of the act expands the definition of that industry to also include the manufacturing or assembling of aircraft engines, blisks, fuselage sections, flight decks, flight deck systems or components, wings, fuselage fairings, fins, wing edges (moving, leading, and trailing), wing boxes, nose sections, tailplanes, passenger doors, nacelles, thrust reversers, landing gear, braking systems, or any combination.

Sales tax refund for research supplies. – Section 31.20 of this act, as amended by Section 14.6 of S.L. 2007-345 (Sec. 14.6, HB 714)[26] expands the authorized sales and use tax refunds contained in G.S. 105-164.14. The new refund is limited to taxpayers who (i) are engaged in analytical services within the State and (ii) increase, in comparison to their 06-07 State fiscal year expenditures, the amount of sales and use tax paid by it in this State on tangible personal property consumed or transformed in analytical service activities. The amount of the refund is 50% of the increased amount of sales and use taxes. A taxpayer must submit a written request to the Secretary of Revenue within six months after the end of the State's fiscal year, including any required documentation and information, in order to receive a refund. This section became effective when the Governor signed it into law on July 31, 2007.

Datacenter sales tax exemption. – Section 31.22 of the act substitutes a privilege tax for the sales and use tax on certain sales of purchases of machinery and equipment located and used at eligible datacenters. This section became effective October 1, 2007, and applies to sales made on or after that date.

Generally, sales of machinery and equipment are taxed at the State rate and the applicable county rate. This section imposes a privilege tax in lieu of the sales and use tax to eligible datacenters for certain purchases. For purposes of this section, an 'eligible datacenter' is a facility (1) that provides infrastructure for hosting or data processing services, (2) that has power and cooling systems that are concurrently maintainable with redundant capacity components and multiple distribution paths serving the facility's computer equipment, (3) that satisfies the wage standard and health insurance requirements of Article 3J, and (4) that the Secretary of Commerce has made a written determination that, at the time of application for the determination, $150 million in private funds has been or will be invested in improvements to real property, machinery, or equipment within five years for development tier one areas. The investment threshold is $300 million for facilities not located in a development tier one area.

Purchases of machinery and equipment by eligible datacenters are subject to the privilege tax in lieu of the sales and use tax where the machinery and equipment (1) is located and used at the datacenter, (2) is capitalized for tax purposes under the Code, and (3) is used to provide datacenter services or for the generation, transformation, transmission, distribution or management of electricity. The rate of tax is 1% of the sales price of the eligible equipment and machinery, capped at $80 per article.

A taxpayer who fails to make the level of investment required for qualification forfeits the application of the privilege tax in lieu of the sales tax and is required to pay all sales and use taxes, with interest, that would have been due on ineligible purchases. Similarly, a taxpayer who does satisfy the investment amount, but fails to use the equipment or machinery at the eligible facility forfeits the application of the privilege tax in lieu of the sales tax with respect to that particular property. A credit, in the amount of the privilege tax paid, is allowed against the sales and use taxes due following forfeiture, and interest is not computed against the amount of this offset. The past taxes and interest are due 30 days after the date of forfeiture.

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[26] The amendment clarifies the intent of the provision which is to provide an incentive to existing companies to increase their work performed in the State. As originally written, the provision rewarded new businesses to the detriment of existing ones.

Tax incentive for railroad intermodal facility. – Section 31.23 of this act, as amended by Section 14.7 of S.L. 2007-345 (Sec. 14.7, HB 714) establishes a tax credit and sales and use tax exemptions and refunds for a taxpayer who constructs or leases and puts into operation an eligible railroad intermodal facility. A railroad intermodal facility is a facility whose primary purpose is to transfer freight between a railroad and another mode of transportation. An 'eligible' railroad intermodal facility is one whose cost of construction[27] exceeds $30 million. Fiscal Research estimates that the tax incentives provided in this section will reduce General Fund availability by $200,000 in FY07-08 and by $300,000 in FY 08-09.

Effective for taxable years beginning on or after January 1, 2007, a taxpayer who constructs or leases an eligible railroad intermodal facility in this State and places it in service during the taxable year is allowed a tax credit. The cost of construction includes the cost of constructing and equipping rail tracks to the facility that are necessary to access and support facility operations.[28] The tax credit is equal to 50% of all amounts payable by the taxpayer towards the costs of construction or under the lease. The tax credit may be taken against either the franchise tax or the income tax. The credit amount taken may not exceed 50% of the tax against which it is applied. Any unused portion of the credit may be carried forward for 10 years. The carryforwards must be claimed against the same tax. The Department of Revenue must report annually on the number of taxpayers claiming this credit, the amount of each credit claimed and the taxes against which it was applied, and the total cost of the credits claimed. The credit expires for taxable years beginning on or after January 1, 2038.

Effective for sales made on or after January 1, 2007, sales to the owner or lessee of an eligible railroad intermodal facility of intermodal cranes, hostler trucks, and locomotives located and used at the facility are exempt from State and local sales and use tax. An owner or lessee of an eligible railroad intermodal facility may also apply for an annual refund of sales and use taxes paid by it on building materials, supplies, fixtures and equipment that become a part of the real property of the railroad intermodal facility. A request for a refund of taxes paid must be submitted within six months after the end of the State's fiscal year (June 30). A refund request received after the due date is barred. Unlike the tax credit, the sales and use tax exemption and refund for an eligible railroad intermodal facility do not have an expiration date.

Part IV: Excise Taxes

University Cancer Research Fund. – Section 6.23 of the act raises the excise tax levied on tobacco products other than cigarettes from 3% to 10%, with the Secretary of Revenue remitting the additional tax to the University Cancer Research Fund (Fund). The increase in the excise tax is effective October 1, 2007, and applies to products acquired on or after the effective date and to taxes paid on or after the effective date. A wholesale or retail dealer of tobacco products other than cigarettes with an inventory of these products as of the effective date are required to file a report of the inventory within 20 days of the effective date with the Secretary and pay the additional tax on the inventory.

This Fund is a special revenue fund in the Office of the President of UNC. Allocations from the Fund are made in the discretion of the Cancer Research Fund Committee but may be

[27] S.L. 2007-345 amended the definition of 'costs of construction', as enacted by this section, to clarify that the term includes constructing and equipping rail tracks to the facility that are necessary to access and support facility operations.
[28] This clarifying language was added to the provision by Section 14.7 of S.L. 2007-345.

used only for the purpose of cancer research under UNC Hospitals or the Lineberger Comprehensive Cancer Center. In the act, the General Assembly found that the State needed to provide at least $50 million per year to the Fund. Each July 1, this sum is transferred to the Fund as follows: (1) $8 million is transferred from the Tobacco Trust Account; (2) all revenue generated by the additional excise tax levied on tobacco products other than cigarettes; and (3) any additional amount needed to raise the total amount to $50 million is appropriated from the General Fund.[29]

The Cancer Research Fund Committee is a seven-member committee with five ex officio members and two appointed members. The five standing members are (i) the President of UNC, who serves at the chair of the committee, (ii) the Director of the Lineberger Comprehensive Cancer Center, (iii) the Dean of the School of Medicine at UNC, (iv) the Dean of the School of Public Health at UNC, and (v) the Dean of the School of Pharmacy at UNC.[30] The five standing members appoint the remaining two members by majority vote. Each appointed member must hold a leadership position in a nationally prominent cancer program. A majority of the committee constitutes a quorum, and the Committee must meet at least once quarterly, with special meetings at the call of the chair or with the written request of a majority of the members.

Cap the variable wholesale component of the motor fuels tax rate for two years. – A motor fuel excise tax is imposed on all motor fuels sold, distributed, or used in the State. The rate of tax consists of a flat rate of 17.5¢ per gallon plus a variable wholesale component equal to the greater of 7% of the average wholesale price of motor fuel during a base six-month base period or 3.5¢ per gallon. In 2006, the General Assembly capped the variable wholesale component of the motor fuels tax at 12.4¢ per gallon, the wholesale rate for the period of January 1, 2006, through January 30, 2006, for a maximum possible rate of 29.9¢ per gallon.

Section 31.15 of the act extends the existing cap for two years, capping the variable wholesale component of the motor fuels tax rate at 12.4¢ per gallon for the period July 1, 2007, through June 30, 2009, for a maximum possible rate of 29.9¢ per gallon.[31] This section became effective when the Governor signed the act into law on July 31, 2007.

Part V: General State & Local Changes

State Assume Medicaid Responsibilities. – Under section 31.16 of the act, as amended by Section 14.4 of S.L. 2007-345 (Section 14.4 of HB 714), the State assumes the counties' share of the nonfederal share of Medicaid costs over a three-year period. To provide the financial resources to assume these costs, this section phases out the third one-half cent local sales tax and makes a corresponding increase in the State sales tax rate. In addition, the legislation changes the distribution of the second one-half cent local sales tax from per capita to point-of-origin. Finally, the section provides for a State hold harmless so that every county will benefit from these changes by at least $500,000 annually.

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[29] The amount appropriated from the General Fund to the Fund for the 2007-08 fiscal year is $5.6 million, and the amount appropriated from the General Fund to the Fund for the 2008-09 fiscal year is $15.5 million.

[30] If any specified position ceases to exist, the successor position, and the person holding it, is deemed substituted.

[31] In addition to the motor fuels tax, the State also charges a motor fuel inspection fee of .25¢ per gallon. The fee increases the motor fuels tax rate from 29.9¢ to 30.15¢ per gallon.

Under previous law, the State was responsible for 85% of the non-administrative, nonfederal share of Medicaid and the counties were responsible for the remainder. This act phases out the county responsibility over three years. Effective October 1, 2007, the State will assume 25% of the counties' share of the non-administrative, nonfederal share of Medicaid costs. Effective July 1, 2008, the State will assume 50% of the counties' share of the non-administrative, nonfederal share of Medicaid costs. Effective July 1, 2009, the State will assume the entire non-administrative, nonfederal share of Medicaid costs. The counties retain responsibility for the costs associated with administering Medicaid at the county level.

To offset the additional costs assumed by the State with respect to Medicaid, the State adjusts the amount distributed from corporate income tax receipts under the Public School Building Capital Fund and gradually assumes one-half cent of local sales and use tax. The adjustment to the ADM funding formula for the Public School Building Capital Fund is for fiscal year 2007-2008 only. If the State assumes more Medicaid payments for FY 07-08 than the county would receive from ADM funding, the amount of the allocation from the Public School Building Capital Fund is reduced by 60%. If the State assumes less Medicaid payments for FY 07-08 than the county would receive from ADM funding, the amount of the allocation from the Fund is reduced by 60% of the county's Medicaid payments assumed by the State for FY 07-08.[32] Effective October 1, 2008, the State begins assuming the third one-half cent local sales and use tax. The act repeals the per capita portion (¼-cent) of the local third one-half cent sales tax, effective October 1, 2008. It increases the State sales tax rate by 0.25%, effective October 1, 2008. Effective October 1, 2009, the act repeals the remaining one-quarter cent of the third one-half-cent local sales tax rate and increases the State sales tax rate by 0.25%.

Effective October 1, 2009, the act changes the allocation of the second one-half cent local sales tax from per capita to point of collection. Beginning July 1, 2009, 1½% of the 2% local tax will be allocated on a point of collection basis and ½% will be allocated on a per capita basis.

The act includes two separate hold harmless provisions. First, counties are required to hold cities harmless with respect to the reduction in local sales and use tax revenue. Second, the State is required to make hold harmless payments to counties to ensure that each county benefits by at least $500,000 as a result of the provisions of this section. In paying this hold harmless amount, the Secretary estimates the repealed sales tax amount, the Medicaid expenditures, and the adjusted ADM payments to determine an estimated hold harmless payment for a county for a fiscal year. The State sends 90% of the estimated hold harmless payment to the county with the March distribution of the local government sales and use taxes. The remainder would be sent no later than August 15th after the Secretary determines the difference between the county's repealed sales tax amount and its hold harmless threshold for the year.

The act makes conforming changes to the transitional hold harmless for repealed reimbursement amounts and to the sales tax distribution to local governments of the State sales tax collected on telecommunications services and video programming services.

[32] In order to lessen the impact on local school administrative units, the act provides that a county must use a portion of the funds available to it, as a result of the assumption by the State of part of the county's Medicaid payments, for public school capital outlay purposes or to implement an approved local school technology plan. The amount it must use for these purposes is the difference between what it would receive from the Fund based on its ADM and the adjusted amount it actually received.

Local Option County Taxes. – Section 31.17 of this act, as amended by Section 14.5 of S.L. 2007-345 (Section 14.5 of HB 714), creates two new taxes, of which counties may choose one to levy if a majority of those voting in a referendum vote for the levy of the tax. This section became effective when the Governor signed it into law on July 31, 2007.

The first option is a land transfer tax on transfers of land within the county. The rate of tax may be up to .4% of the greater of the value of or consideration paid for the property, and the rate must be an increment of .1%. The land transfer tax is in addition to the excise stamp tax on conveyances of land, and land exempt from the stamp tax is also exempt from the land transfer tax. The tax is administered in the same manner as the stamp tax. The tax becomes effective on the first day of the month specified in the resolution but may not be earlier than the first day of the month that is two months after the resolution is adopted. Proceeds of the transfer tax may be used for any lawful purpose, and repeal or reduction of the tax may be by resolution, effective the first day of the month but not until the end of the fiscal year. Repeal or reduction does not affect a then-existing liability or right to a refund.

As an alternative to the land transfer tax, Section 31.17 also authorizes a second option, a one-quarter cent sales and use tax. The rate of tax is .25% of the sales price of the item, in addition to all other State and local sales and use taxes, except for purchases of food exempt from tax under G.S. 105-164.13B. The adoption, levy, collection, administration, and repeal of this sales and use tax are in accordance with the first one-cent local sales and use tax (Article 39 of Chapter 105 of the General Statutes). The amount collected within the county goes solely to the county; no amount is allocated to the municipalities within the county.

Finally, this section resolves administrative concerns regarding when the combined general rate increases. Cable and satellite services, telecommunications, ancillary services, and liquor are subject to the combined general rate, all of which the State retains. During discussion on this provision, questions arose as to when the combined general rate would change relative to the adoption or levy of the quarter-cent local sales and use tax authorized by this section. Accordingly, G.S. 105-164.15A makes clear that the combined general rate change occurs for increases in authorization for local sales and use taxes on the date when local sales and use taxes become effective in the first county or group of counties to levy the authorized tax. For repeals of the authorization for local sales and use taxes, the change is effective on the effective date of the repeal. The effective date of a change in the State general rate of tax would also be the effective date for a change in the combined general rate.

Part VII: Capital Appropriations

Special Indebtedness Projects. – Section 29.13 of the act authorizes approximately $550,000,000 of special indebtedness to pay the capital facility costs of various University and State facilities over the next three fiscal years.

Land for Tomorrow and Waterfront Access and Marine Industry Fund. – Section 29.14 of the act authorizes $120,000,000 of special indebtedness to finance the costs of land acquisitions, waterfront properties, and the development of facilities for the purposes of providing and improving public and commercial waterfront access. Of this amount, $50,000,000 is allocated for land acquisitions for the expansion of the State Park System; $50,000,000 is allocated for land acquisition to conserve ecological diversity of the State; and $20,000,000 is allocated for waterfront access and the development of facilities to provide waterfront access. The Parks and Recreation Trust Fund will reimburse the General Fund for debt service on special indebtedness issued to acquire land for the State Park System and to acquire waterfront access. The Natural Heritage Trust Fund will reimburse the General Fund for debt service on special indebtedness issued to acquire land to conserve ecological diversity.[33]

Sales Tax Exemption for Baked Goods.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-368	**SB 1240**	**Senator Kerr**

AN ACT TO ENSURE THAT ALL BREAD SOLD AT A BAKERY THRIFT STORE IS TAXED AT THE SAME SALES TAX RATE.

OVERVIEW: This act exempts bread, rolls, and buns sold at a bakery thrift store from State sales tax.

FISCAL IMPACT: This act will have a minimal impact on State and local government sales tax revenues. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective October 1, 2007, and applies to sales made on or after that date.

ANALYSIS: The Streamlined Sales Tax Agreement (Agreement) requires member States to treat terms defined under the Agreement consistently. For items that are not defined, a State may enact entity-based exemptions, notwithstanding that the items might be included in a broader product definition under the Agreement.

Prepared food, a defined term under the Agreement, is taxed at the combined State and local sales tax rate in North Carolina irrespective of whether it is intended for home consumption. If a baked good[34] meets the definition of a prepared food, it is subject to the combined rate; if not, it is exempt from State tax and subject only to the local sales tax on food.

This act exempts bread, rolls, and buns that otherwise meet the definition of a prepared food from the State sales tax when sold at a bakery thrift store, which is defined as a retail outlet of a bakery that sells at wholesale over 90% of the items it makes and sells at the retail outlet day-old bread, rolls, and buns returned to it by retailers that acquired those items from the bakery.

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[33] G.S. 113-77.9(b3) is amended to increase the percentage of money in the Natural Heritage Trust Fund that may be used to reimburse the General Fund for debt service from 50% to 60%.

[34] The term 'baked goods' includes bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, and tortillas when those goods are prepared by the retailer by mixing or combining two or more foods for sale as a single item.

Interest on Illegally Levied Exactions.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-371	**SB 1152**	**Senator Hoyle**

AN ACT TO REQUIRE COUNTIES AND CITIES TO PAY INTEREST ON ILLEGALLY EXACTED TAXES, FEES, OR MONETARY CONTRIBUTIONS FOR DEVELOPMENT THAT ARE NOT SPECIFICALLY AUTHORIZED BY LAW.

OVERVIEW: This act requires cities and counties to pay 6% annual interest on any illegally exacted tax, fee, or monetary contribution for development or a development permit.

FISCAL IMPACT: No impact on State revenues. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective when signed into law by the Governor on August 19, 2007, and applies to actions filed on or after that date.

ANALYSIS: The genesis of this act was a ruling by the North Carolina Court of Appeals in the case of *Durham Land Owners Association v. County of Durham*[35] in which the Court invalidated a local ordinance authorizing the assessment of school impact fees on developers for new home construction.[36] The plaintiffs, a group of developers and homebuilders, challenged the ordinance on the grounds that Durham County did not have proper enabling legislation from the General Assembly. The County argued that it had general authority to levy 'fees and commissions' to carry out duties required by law and did not need specific legislative authority to levy the impact fees. The trial court agreed with the plaintiffs and ordered that the County refund the payments, totaling approximately $8 million, with interest.

While the North Carolina Court of Appeals upheld the trial court's decision to invalidate the ordinance and refund the money collected, it reversed the award of interest. In reaching this decision, the Court examined the relevant statute and prior case law and concluded that there was no precedent for changing the 'long standing rule' that the State and its political subdivisions do not pay interest under G.S. 24-5 on judgments against it. G.S. 24-5 sets out the rate of interest and the manner in which it accrues on judgments. The statute does not specifically authorize the accrual of interest on judgments against the State or its political subdivisions. Without specific authorization, governmental immunity precludes the accrual of interest when the unit of government is engaged in a governmental function. In this case, Durham County was exercising a governmental function when it imposed a school construction fee without appropriate authority.

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[35] 177 N.C.App. disc. review denied, 629, 360 N.C. 532.

[36] Between 1985 and 1991, the General Assembly gave three counties and several municipalities the authority to implement impact fees. Impact fees are charged by local governments to developers who wish to construct new properties. The revenue from the impact fees are used to pay for the construction of public facilities necessitated by the development. Since 1991, the General Assembly has not given any local government new impact fee authority. In 2003, Durham became the first North Carolina county to create impact fees without a specific legislative mandate.

In response, the General Assembly passed this act granting specific statutory authority for the accrual of interest at the rate of six percent (6%) per annum on judgments entered against a city or county for the illegal exaction of a tax, fee, or monetary contribution for development or a development permit not specifically authorized by law. However, the act does not apply to the *Durham* case because the effective date makes it clear that the act applies only to actions filed on or after the effective date of August 19, 2007.

Modifications to Project Dev. Financing Act.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-395	**SB 1196**	**Senator Clodfelter**

AN ACT TO MODIFY THE PROJECT DEVELOPMENT FINANCING ACT.

OVERVIEW: This act does two things:

- It allows local governments to use the proceeds of project development financing debt instruments to provide parks and recreation facilities, community college facilities, and school facilities.
- It removes the requirement that the base valuation of a development financing district be increased as the result of an increase in valuation due to revaluation.

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective when signed into law by the Governor on August 20, 2007.

ANALYSIS: In November 2004, the voters approved a constitutional amendment that has enabled counties, cities, and towns to use project development financing for the public portion of certain economic development projects within a defined territorial area. Project development financing, also known as tax increment financing, allows a local government to issue bonds secured by the incremental property tax increase generated by the development financed. This financing mechanism can be used for airports, auditoriums and arenas, hospitals, museums, parking facilities, sewer systems, storm sewers and flood control facilities, water systems, street improvements, public transportation facilities, railroads, affordable housing, land development for industrial or commercial purposes, utilities, and redevelopment. Prior to the bonds being issued, the local government must adopt a development financing plan describing the projects to be financed and how the tax proceeds will be used. The local government must also obtain approval from the Local Government Commission.

Once the district has been established and the project development financing debt instruments have been approved, the local government must notify the county tax assessor who must determine the base valuation of the district. The base valuation is the assessed value of all taxable property located in the district on the January 1 immediately preceding the effective date of the district. The base valuation may be adjusted if property is removed or added to the district. The base value may also be increased if the property values of the district increase as the result of a revaluation. Each year the tax assessor must determine the current assessed value of taxable property in the district. To the extent the current value exceeds the base value, the difference is the incremental valuation of the district. Property taxes levied on the incremental valuation of the district are placed in a separate fund and may be used to finance capital expenditures in the district, to meet principal and interest requirements on project development financing debt instruments, to repay moneys expended on debt service of project development financing debt instruments, and to establish and maintain debt service reserves.

This act makes the following changes to the project development financing act:

- It includes parks and recreation facilities, excluding stadiums, arenas, golf courses, swimming pools, wading pools, or marinas, among the purposes for which project development financing may be used. Included in this category, by reference, are the following: athletic fields, parks, playgrounds, recreation centers, shelters, permanent and temporary stands, and lighting.[37]

- It includes community college facilities[38] and school facilities[39] among the purposes for which project development financing may be used.

- It allows project development financing to be used for services and facilities authorized to be provided in a municipal service district without the creation of such a district. Under prior law, the proceeds of project development financing could be used for any service or facility authorized by G.S. 160A-536 and provided in a municipal service district. The act provides that no municipal service district needs to be created for the purpose of expending the funds. The formation of a municipal service district requires substantially the same steps as are required in the creation of a development financing district and is unnecessary duplication.

- It removes the requirement to increase the base valuation of a development financing district if property values of the district as they existed on the January 1 immediately preceding the effective date of the district are increased by a revaluation. The rationale for the removal of this requirement is that the statute already requires any excess revenues be paid to the taxing entity and that the benefit, if any, to the taxing entity as the result of the adjustment is outweighed by the complicated and unclear procedure regarding how the adjustment should be made.

[37]G.S. 159-48(b)(13).
[38]G.S. 159-48(c)(1).
[39]G.S. 159-48(c)(4).

Promote Renewable Energy/Baseload Generation.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-397	**SB 3**	**Senator Albertson**

AN ACT TO: (1) PROMOTE THE DEVELOPMENT OF RENEWABLE ENERGY AND ENERGY EFFICIENCY IN THE STATE THROUGH IMPLEMENTATION OF A RENEWABLE ENERGY AND ENERGY EFFICIENCY PORTFOLIO STANDARD (REPS), (2) ALLOW RECOVERY OF CERTAIN NONFUEL UTILITY COSTS THROUGH THE FUEL CHARGE ADJUSTMENT PROCEDURE, (3) PROVIDE FOR ONGOING REVIEW OF CONSTRUCTION COSTS AND FOR RECOVERY OF COSTS IN RATES IN A GENERAL RATE CASE, (4) ADJUST THE PUBLIC UTILITY AND ELECTRIC MEMBERSHIP CORPORATION REGULATORY FEES, (5) PROVIDE FOR THE PHASEOUT OF THE TAX ON THE SALE OF ENERGY TO NORTH CAROLINA FARMERS AND MANUFACTURERS, AND (6) ALLOW A TAX CREDIT TO CONTRIBUTORS TO 501(C)(3) ORGANIZATIONS FOR RENEWABLE ENERGY PROPERTY.

OVERVIEW: This act makes the following tax related changes. The remainder of this act does not affect North Carolina tax laws and is not discussed below.[40]

- It phases out the sales taxes paid by farmers and manufacturers for electricity, piped natural gas, and other fuels.
- It establishes a tax credit for entities that provide funds to a 501(c)(3) for renewable energy property.

FISCAL IMPACT: Sections 10 through 12 of the act, which phase out the tax on electricity, piped natural gas, and fuel used by manufacturers to operate their industries, and by farmers in their farming operations, over a four-year period, have the following fiscal impact:

FY 2007-08 $(10.0 million)
FY 2008-09 $(20.0 million)
FY 2009-10 $(30.0 million)
FY 2010-11 $(45.0 million)
FY 2011-12 $(44.0 million)

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)

[40] For a summary of those provisions, see Chapter 11 of the *Summaries of Substantive Ratified Legislation* publication available online and in the Legislative Library.

EFFECTIVE DATE: The sales tax changes are effective over a three-year period, beginning October 1, 2007. The tax credits become effective for taxable years beginning on or after January 1, 2008.

ANALYSIS: This act establishes Renewable Energy Portfolio Standards (REPS) for North Carolina utilities. A REPS require utilities to provide a designated amount or percentage of power from renewable energy resources as a portion of their overall provision of electricity. Iowa enacted the first REPS in 1991 and as of June 2007, REPS have been enacted by the majority of the 24 states and the District of Columbia that have adopted standards requiring electric utilities to generate electricity from renewable resources. Over half of the American public lives in a state in which a REPS is in effect. States have adopted or expanded their REPS for many reasons including: economic development benefits through the promotion of a state's renewable energy resources; potential for jobs creation; prospect of increased reliability in electricity supply; and reduction of conventional air pollutants and greenhouse gases.

Phase Out-of-State Taxes Paid by Farmers and Manufacturers on Electricity, Piped Natural Gas, and Other Fuels

Section 10 of the act phases out the current sales tax rate of 2.83%[41] on sales of electricity to manufacturing industries and manufacturing plants[42] for use in connection with their operations and to farmers when used by them for farming purposes. Effective October 1, 2007, the rate is reduced to 1.8%. Effective July 1, 2008, the rate is reduced to 1.4%. Effective July 1, 2009, the rate is reduced to .8%, and effective July 1, 2010, the sales tax on these sales is entirely eliminated.

Section 11 of the act phases out the sales tax imposed on piped natural gas[43] received by a manufacturer for use in connection with the operation of a manufacturing facility and on piped natural gas received by a farmer to be used for any farming purpose other than preparing food, heating dwellings, and other household purposes. The tax is phased out over a four-year period, beginning October 1, 2007, with end-users being exempt as of July 1, 2010.

Section 12 of the act phases out the current privilege tax rate of 1%, subject to an $80 cap, of the sales price of fuel imposed on a manufacturing industry or plant that purchases fuel to operate the industry or plant.[44] Effective October 1, 2007, the rate is reduced to .7%. Effective July 1, 2008, the rate is reduced to .5%. Effective July 1, 2009, the rate is reduced to .3%, and effective July 1, 2010, the privilege tax is entirely eliminated.

Renewable Energy Tax Credits

Current law provides a tax credit for investing in renewable energy property. However, a nonprofit corporation cannot take advantage of this credit when it invests in renewable

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[41] The general rate of tax on sales of electricity is 3%. Sales of electricity to an aluminum smelting facility are taxed at a rate of 1%, but that rate expires for sales made on or after October 1, 2007.

[42] In S.L. 2006-66, the tax on sales of electricity to manufacturing industries and manufacturing plants was reduced from 2.83% to 2.6%, effective July 1, 2007. This act repeals that reduction and replaces it with the 1.8% rate, as provided.

[43] The tax on piped natural gas applies uniformly to all users but is structured as a declining block that decreases as the amount of therms of piped gas consumed in a month increases. Thus, low-volume users pay a higher effective rate of tax than high-volume users.

[44] Manufacturers and farmers are exempt from sales tax on purchases of fuel.

energy property because the nonprofit organization does not owe any tax. Section 13 of this act allows a tax credit to a taxpayer who donates money to a tax-exempt nonprofit organization[45] for the purpose of providing funds for the organization to construct, purchase, or lease renewable energy property[46] where the nonprofit organization uses the donated funds to invest in renewable energy property. The tax credit may be taken against either the franchise tax or the income tax of the taxpayer. A taxpayer who claims this credit may not also claim the donation as a charitable contribution. Moreover, the total amount of the credit may not exceed the amount of the credit the nonprofit organization could claim under G.S. 105-129.16A if it were subject to tax, which for non-residential property, is capped at $2,500,000.[47]

The amount of the credit is equal to the taxpayer's share of the credit the nonprofit organization could claim under G.S. 105-129.16A if the nonprofit organization were subject to tax or 35% of the cost of the property placed in service. The taxpayer's share of the credit is equal to the following calculation: (taxpayer's donation / cost of the renewable energy property of the nonprofit organization placed in service that year as a result of the donation) X (the amount of the credit the nonprofit organization could claim if it were subject to tax). The credit must be taken in the year in which the property is placed in service.[48]

A nonprofit organization must keep a record of all donations it receives for renewable energy property and the amount of the donations used for this purpose. If a nonprofit organization places renewable energy property in service, the nonprofit organization must give each taxpayer who made a donation a statement setting out the amount of the credit the taxpayer qualifies for, a description of the renewable energy property placed in service, the cost of the property, the amount of the credit the nonprofit organization could claim under G.S. 105-129.16A if it were subject to tax, and the taxpayer's share of the credit allowed. If the donations made for the renewable energy property exceed the cost of the property, the nonprofit organization must prorate each taxpayer's share of the credit.

[45] A tax-exempt, nonprofit organization is one that is exempt from tax under section 501(c)(3) of the Code.

[46] Renewable energy property includes biomass equipment that uses renewable biomass resources for biofuel production of ethanol, methanol, and biodiesel; anaerobic biogas production of methane utilizing agricultural and animal waste or garbage; commercial thermal or electrical generation from renewable energy crops or wood waste materials; hydroelectric generators; solar energy equipment; and wind equipment. Renewable biomass resources are organic matters produced by terrestrial and aquatic plants and animals.

[47] The maximum credit amount is less for residential property. For residential property, the following ceilings apply: $1,400/dwelling for solar energy equipment for domestic water heating; $3,500/dwelling for solar energy equipment for active space heating, combined active space and domestic hot water systems, and passive space heating; and $10,500/installation for any other renewable energy property.

[48] The installment requirements in G.S. 105-129.16A for nonresidential property do not apply to this credit.

Extend Qualified Business Venture Tax Credit.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-422	**HB 1598**	**Rep. Gibson, Owens, Daughtridge, Wainwright**

AN ACT TO EXTEND THE SUNSET ON THE TAX CREDITS FOR QUALIFIED BUSINESS INVESTMENTS AND TO EXTEND THE TIME FOR FILING AN APPLICATION TO OCTOBER 15.

OVERVIEW: This act extends the sunset on the tax credits for qualified business investments from January 1, 2008, to January 1, 2011. It also extends the time for which a credit application may be filed from September 15 to October 15.

FISCAL IMPACT: The total amount of all tax credits for qualified business investments may not exceed $7,000,000 a year. Demand for the credit exceeded $7,000,000 in 2006 and is expected to continue to be equal to, or greater, than the cap in future years. The fiscal impact of extending the tax credit through tax year 2010 is $7,000,000 for each of the respective fiscal years. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The extension of the application filing deadline became effective January 1, 2008, and applies to applications filed on or after that date. The remainder of the act became effective when signed into law by the Governor on August 23, 2007.

ANALYSIS: This act extends the qualified business investment tax credit through tax year 2010. The qualified business investment tax credit is allowed for an individual taxpayer who invests in a qualifying small business. A qualifying small business is one of the following:

- Qualified business venture. – A business that engages primarily in manufacturing, processing, warehousing, wholesaling, research and development, or a service-related industry.[49] Its annual gross revenues may not exceed $5,000,000.
- Qualified grantee business. – A business that has received during the current year or any of the preceding three years a grant, an investment, or other funding from a federal agency under the Small Business Innovation Research Programs. Its annual gross revenues may not exceed $1,000,000.
- Qualified licensee business. – A business that has been certified by a constituent institution of The University of North Carolina or a research university as currently performing under a licensing agreement with the institution or university for the purpose of commercializing technology developed at the institution or university.

[49] A qualified business venture does not include a real estate-related business, a business that was formed for the primary purpose of acquiring all or part of the stock or assets of one or more existing businesses, or a business that is substantially engaged in one or more of the following: providing a professional service; construction or contracting; selling or leasing at retail; the purchase, sale, or development of commercial paper, notes, other indebtedness, securities, or real property, otherwise makes investments; providing personal grooming or cosmetics services; or offering any form of entertainment, amusement, recreation, or athletic or fitness activity for which an admission or a membership is charged.

The credit is equal to 25% of the amount invested and may not exceed $50,000 per individual in a single taxable year. If the investor is a husband and wife, the $50,000 limitation applies to the couple as one entity if the investment is made from joint funds and the stock certificate is issued in both names. However, if the couple made separate investments, as indicated by the use of separate funds and by the issuance of stock certificates in separate names, then the $50,000 limitation applies to each individual. An individual investor may also claim the allocable share of credits obtained by pass-through entities[50] of which the investor is an owner.

The credit may not be taken in the year the investment is made. Instead, the credit is taken in the year following the calendar year in which the investment was made, but only if the taxpayer files an application with the Secretary of Revenue. Prior to January 1, 2008, an application for the credit had to be filed on or before April 15 of the year following the calendar year in which the investment is made. The Secretary could grant extensions of this deadline, so long as the application was filed on or before September 15. The Secretary could not accept an application for the credit filed after September 15. The act provides that the application should be filed by April 15, but may be filed on or before October 15. This change removes the requirement that a taxpayer request an extension of time to file an application if the application is filed after April 15. The date of October 15 coincides with the income tax extension date.

The amount of credit a taxpayer may claim may not exceed the taxpayer's tax liability. Any unused credit may be carried forward for the next five years. The total amount of credits allowed to all taxpayers for investments made in a calendar year may not exceed $7 million.[51] The Secretary of Revenue calculates the total amount of tax credits claimed from applications filed. If the amount exceeds the cap, then the Secretary allows a portion of the tax credits claimed by allocating the total of $7 million in tax credits in proportion to the size of the credit claimed by each taxpayer. A taxpayer forfeits the credit if the taxpayer transfers the securities within one year or the qualified business redeems the securities purchased by the taxpayer within five years after the investment was made.

The purpose of the credit is to stimulate early stage investments that help move new technologies from universities and other research laboratories to commercialization. Since 1999, investors using the North Carolina qualified business venture tax credit have claimed approximately $48 million in credits and generated more than $274 million in credit-eligible capital contributions to qualifying small companies. Demand for the credit exceeded $7 million in 2006.

[50] Pass-through entities include limited partnerships, general partnerships, S corporations, and limited liability companies.

[51] The General Assembly increased the cap from $6 million to $7 million in 2004 (S.L. 2004-124, Part 32C).

Qtrly Escrow Deposits/Affiliated Dealers.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-435	**HB 1460**	**Representative Cole**

AN ACT TO ALLOW THE ATTORNEY GENERAL TO REQUIRE CERTAIN CIGARETTE MANUFACTURERS TO MAKE QUARTERLY ESCROW DEPOSITS, TO TREAT CERTAIN AFFILIATES OF A MANUFACTURER OF OTHER TOBACCO PRODUCTS AS IF THEY WERE THE MANUFACTURER FOR PURPOSES OF ADMINISTRATION OF THE EXCISE TAX ON OTHER TOBACCO PRODUCTS, AND TO PROVIDE THAT THE PERMISSION GRANTED TO A CIGARETTE MANUFACTURER TO BE RELIEVED OF PAYING THE CIGARETTE EXCISE TAX APPLIES TO ALL TOBACCO PRODUCTS DISTRIBUTED BY THE MANUFACTURER.

OVERVIEW: This act does two different things.

- It requires certain tobacco product manufacturers who chose not to participate in the Master Settlement Agreement (NPM) to make their escrow deposits on a quarterly basis rather than an annual basis.
- It defines the term 'integrated wholesale dealer' as a wholesale dealer who is an affiliate of a manufacturer of other tobacco products and is the only person to whom the manufacturer sells its products. The act also provides that an integrated wholesale dealer is treated like a manufacturer for purposes of allowing relief from paying the excise tax on other tobacco products (OTP).

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The requirement that NPM make escrow payments quarterly became effective January 1, 2008. The remainder of the act becomes effective October 1, 2007.

ANALYSIS: This act does two different things. First, it requires certain tobacco product manufacturers who chose not to participate in the Master Settlement Agreement (NPM) to make their escrow deposits on a quarterly basis rather than an annual basis. Requiring more frequent payments from a free cash flow standpoint puts pressure on NPMs to make sure they are collecting enough revenue from their cigarette sales to be able to comply with the escrow payment obligations. Several states have begun to require NPMs to make quarterly payments to better ensure compliance with the MSA. The quarterly escrow payment obligation applies to the following NPMs:

- A NPM that has not previously established and funded a qualified escrow fund in NC.
- A NPM that has not made any escrow deposits for more than one year.

- A NPM that has failed to make a timely and complete escrow deposit in any prior calendar year.
- A NPM that has failed to pay any judgment.
- Any NPM that the Attorney General has reasonable cause to believe may not make its full required escrows deposit by April 15 of the year following the year in which the cigarette sells are made.

Second, the act defines the term 'integrated wholesale dealer' as a wholesale dealer who is an affiliate of a manufacturer of other tobacco products and is the only person to whom the manufacturer sells its products. The act also provides that an integrated wholesale dealer is treated like a manufacturer for purposes of allowing relief from paying the excise tax on other tobacco products (OTP). The excise tax on OTP is paid by the wholesale dealer or retail dealer who first acquires or otherwise handles OTP. A manufacturer who is not a retail dealer and who ships other tobacco products to either a wholesale dealer or a retail dealer may apply to the Secretary to be relieved of paying the tax. Once granted permission, a manufacturer may choose not to pay the tax, which would result in the tax being paid by the wholesale or retail dealer. This part of the act became effective October 1, 2007.

An example of an integrated wholesale dealer is Conwood Sales, which is an affiliate of Reynolds American, Inc., and one of its subsidiaries, Conwood Company. Under prior law, Conwood Sales would be required to pay the excise tax on the products it receives from Conwood Company because it is a wholesale dealer and the first company in the State to handle the products produced by its affiliate, Conwood Company. Accordingly, if Conwood Company, as the manufacturer, were granted permission by the Secretary of Revenue to be relieved of paying the excise tax on the products it produces, this permission would not apply to Conwood Sales. Under this act, Conwood Company and Conwood Sales would be considered the same entity for purposes of paying the excise tax on OTP. Therefore, if Conwood Company receives permission to be relieved of paying the excise tax on other tobacco products, then that permission applies to Conwood Sales as well because Conwood Sales is an integrated wholesale dealer of Conwood Company. The result is that the wholesale and retail dealers who purchase products from Conwood Sales would pay the excise tax.

Historic Rehabilitation Tax Credit.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-461	**HB 1259**	**Representative Howard**

AN ACT TO REMOVE THE SUNSET ON THE PASS-THROUGH ENTITY ALLOCATION PROVISIONS OF THE HISTORIC REHABILITATION TAX CREDIT.

OVERVIEW: This act allows a pass-through entity to continue to allocate the historic rehabilitation tax credit among its owners in its discretion.

FISCAL IMPACT: Minimal impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The act became effective when signed into law by the Governor on August 28, 2007.

ANALYSIS: North Carolina allows an income tax credit[52] to taxpayers that qualify for the federal historic rehabilitation tax credit.[53] The amount of the credit is equal to 20% of the expenses of rehabilitating an income-producing historic structure.[54] A pass-through entity may qualify for the rehabilitation credit and pass the credit on to its owners.[55]

For most State tax credits, a pass-through entity is required to allocate the credit among its owners in the same proportion that other items, such as the federal rehabilitation credit, are allocated under the Internal Revenue Code. Under the Internal Revenue Code, tax credits are allocated among S corporation shareholders in accordance with their pro rata share of the corporation, which is determined on the basis of stock ownership,[56] and tax credits are allocated among partners in a partnership in accordance with the partnership agreement.[57]

However, in 1999, the General Assembly allowed a pass-through entity to allocate the historic tax credit for income-producing property among its owners in its discretion. The allocation of the credit allows the tax credit to be utilized more fully since it can be redistributed to North Carolina investors with State income tax liability. The provision of State law allowing this allocation would have expired for taxable years beginning on or after January 1, 2008.[58] This act repeals the sunset so that the credit may continue to be allocated among the owners of a pass-through entity in the entity's discretion. The credit itself has no sunset. Each year an allocated credit is claimed, the pass-through entity and its owners must include a statement with their tax return showing both the allocation made and the allocation that would otherwise have been required under G.S. 105-131.8 or G.S. 105-269.15. The owner's adjusted basis in the pass-through entity must be equal to at least 40% of the amount of credit allocated to the owner.[59]

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[52] G.S. 105-129.35. The credit may not be taken for the tax year the property is placed in service but must be taken in installments over five years after the historic structure is placed in service. Any unused portion of a credit may be carried forward for a five-year period.

[53] The federal tax credit is available for rehabilitating only income-producing historic structures. The federal credit amount is equal to 20% of the rehabilitation expenses.

[54] North Carolina also allows an income tax credit of 30% of the expenses of rehabilitating an historic structure that is not income-producing, and thus not eligible for the federal income tax credit.

[55] A pass-through entity is an entity, such as a partnership, a limited liability company, or a Subchapter S corporation, that is treated as owned by individuals or other entities under federal tax law and whose income, losses, and credits are reported by the owners on their State income tax returns.

[56] State law provides that the tax credit allowed a shareholder in a Subchapter S corporation is based on the percentage of stock held by the shareholder in the corporation. G.S. 105-131.8.

[57] State law provides that the tax credit allowed a partner is based on the partnership agreement, which must have substantial economic effect, which means that the allocation agreement must reflect the economic interest of the partners in the partnership and cannot be based solely on tax consequences. G.S. 105-269.15.

[58] The original provision enacted in 1999 would have expired in 2002. S.L. 2001-476 extended the provision for two years and S.L. 2003-415 extended it for four years.

[59] S.L. 2003-415. Prior to 2003, the amount of credit allocated to an owner could not exceed the owner's adjusted basis in the entity.

Amend Combined MV Registration and PT System.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-471	**HB 1688**	**Representative Folwell**

AN ACT TO AUTHORIZE THE DIVISION OF MOTOR VEHICLES TO CREATE A LIMITED REGISTRATION PLATE, TO EXEMPT MOTOR VEHICLES REGISTERED UNDER THE INTERNATIONAL REGISTRATION PLAN FROM THE COMBINED REGISTRATION AND PROPERTY TAX SYSTEM, TO PROVIDE THAT INTEREST GENERATED BY FUNDS IN THE COMBINED MOTOR VEHICLE AND REGISTRATION ACCOUNT BE CREDITED TO THE ACCOUNT, TO AUTHORIZE THE OFFICE OF STATE BUDGET AND MANAGEMENT TO DIRECT THE TREASURER TO DISTRIBUTE THE FUNDS IN THE ACCOUNT TO IMPLEMENT THE INTEGRATED COMPUTER SYSTEM, TO DISTRIBUTE ANY REMAINING FUNDS IN THE ACCOUNT TO THE LOCAL GOVERNMENTS, AND TO MAKE TECHNICAL AND CLARIFYING CHANGES TO THE COMBINED MOTOR VEHICLE REGISTRATION RENEWAL AND PROPERTY TAX COLLECTION SYSTEM.

OVERVIEW: This act makes the following changes to the combined motor vehicle registration and property tax collection system that was created in S.L. 2005-294:

- Creates a limited registration plate designed and issued by the Division of Motor Vehicles (DMV). A licensed motor vehicle dealer will be authorized to issue this limited plate to a purchaser of a motor vehicle after the dealer submits an application for title and registration fees to the DMV. Persons buying vehicles from someone other than a dealer may also obtain the limited plate upon submitting an application for title and payment of registration fees. The limited plate may allow a purchaser of a motor vehicle up to 90 days to pay property taxes on the vehicle.

- Exempts all motor vehicles registered under the International Registration Plan from the combined motor vehicle registration renewal and property tax collection system.

- Provides that the interest generated by the funds in the Combined Motor Vehicle and Registration Account located in the Treasurer's Office shall be credited to the Account. These funds will not be transferred by the Office of State Budget and Management and appropriated by the General Assembly until the Department of Transportation and the North Carolina Association of County Commissioners reach agreement on a project plan for an integrated computer system. Any funds remaining in the Account after the system is in operation will be distributed to the local governments on a pro rata basis.

- Makes technical and conforming changes to the combined motor vehicle registration renewal and property tax collection system.

FISCAL IMPACT:

Description	*Local Government Impact*
IT and Computer System Modifications	$794,000 costs for 2009-2010
Limited Registration Plates / Temporary Stickers	$854,545 costs for 2009-2010 $854,545 costs for 2010-2011 $854,545 costs for 2011-2012
Mailing notice of limited plate expiration date / Notice to renew	$1,860,429 costs for 2009-2010 $1,860,429 costs for 2010-2011 $1,860,429 costs for 2011-2012.
Local Plate Agency Fee for Collecting Payment	No estimate available at this time
Other Costs associated with implementation of S.L. 2005-294 and HB1688	No estimate available at this time
New Positions	No estimate available at this time

The above costs will be covered through the Combined Motor Vehicle and Registration Account that local governments pay into, held within the State Treasurer's Office. These funds will not be utilized until the North Carolina Association of County Commissioners approves DMV's plan of expenses and the General Assembly appropriates the funds. This Account currently has approximately $6 million for the program. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: Unless otherwise stated in the Analysis below, this act becomes effective July 1, 2010, or when the Division of Motor Vehicles and the Department of Revenue certify that the integrated computer system for registration renewal and property tax collection for motor vehicles is in operation, whichever occurs first.

ANALYSIS: In 2005, the General Assembly enacted legislation that will combine the registration for and the property tax billing and collection of motor vehicles into a combined process beginning July 1, 2010, or earlier if a combined registration and tax collection computer system is in operation before that date.[60] Instead of the Division of Motor Vehicles (DMV) sending a statement and collecting annual registration fees on one date and the county sending a statement and collecting annual property taxes on a different date, the combined system will require one statement containing all registration fees and property taxes due on the vehicle. The fees and taxes may be paid to the DMV or a DMV agent on the same date. Until the combined system is in operation, the county in which the motor vehicle is registered will continue to assess the vehicle for property taxes on a revolving, year-round basis, and the DMV will continue to collect vehicle registration fees. The goals of the combined system are to reduce the number of taxpayer interactions with government,

[60] S.L. 2005-294, as amended by Section 31.5 of S.L. 2006-259.

save money, increase the overall efficiency of both functions, and improve the property tax collection rate on motor vehicles.

The act makes several changes to the combined motor vehicle registration renewal and property tax collection system described as follows:

Creation of Limited Registration Plates

The act creates a new limited registration plate that will give motor vehicle dealers the option of collecting property taxes on a vehicle sold by them and allow the purchaser of the motor vehicle up to 90 days in some cases to pay the property taxes due on the motor vehicle. A purchaser of a motor vehicle from anyone other than a dealer will also be allowed to obtain the new limited registration plate. Under the combined system, which goes into effect July 1, 2010, or earlier if the integrated computer system is in operation before this date, property taxes on a motor vehicle are due at the time of vehicle registration or renewal of registration. The combined system will require a dealer, who is authorized to issue a 30-day temporary registration plate under G.S.20-79.1[61] to collect property taxes on a vehicle when a customer purchases a vehicle from the dealer and does not transfer his or her tag. The act makes the collection of property taxes by a dealer voluntary. Under the act, a dealer, who is authorized to issue a 30-day temporary tag under current law, must also provide a purchaser of a motor vehicle with a subsequent limited registration plate designated 'temporary', if the dealer does not want to collect the property taxes from the purchaser. After collecting an application for title and the registration fees from the purchaser, the dealer must provide the purchaser with the 30-day temporary tag and submit the title application and registration fees to the DMV or its authorized agent. The dealer must then provide the purchaser with the limited plate. The limited plate will expire on the last day of the second month following the date of the application of the limited registration plate. The Property Tax Division within the Department of Revenue must mail a notice to the purchaser indicating the date on which the limited plate will expire, that registration fees have been paid, and that the registration becomes valid for the remainder of the year upon payment of county and municipal taxes and fees due in the current year.

Exempt International Registration Plan Vehicles

The act exempts all classified motor vehicles registered under the International Registration Plan (IRP) from the combined motor vehicle registration and property tax collection system. The IRP is a registration reciprocity compact among 48 states, the District of Columbia, and 10 Canadian Provinces, and provides for the payment of license fees for vehicles based upon the total distance operated in all jurisdictions.[62] Under current law, fleet vehicles owned by public service companies are exempt form the definition of classified motor vehicles and, therefore, are exempt from the combined system. The Department of Revenue determines the assessed value of these fleet vehicles by apportioning a fair and reasonable share of the value of the company using property, business, and mileage factors, and allocating the valuations of the property among the local taxing units. Each local taxing unit then applies

[61] G.S. 20-79.1 requires a dealer, who is authorized to issue a temporary registration plate to a purchaser, to first obtain a written application for titling and collect the registration fees from the purchaser, before providing the purchaser with the temporary plate.
[62] The IRP applies to any of the following vehicles: (a) a vehicle having two axles and a gross vehicle weight in excess of 26,000 pounds, (b) a vehicle having three axles or more regardless of weight, or (c) a vehicle when the combination exceeds 26,000 pounds gross vehicle weight and the vehicle travels in two or more jurisdictions.

its tax rate to the apportioned valuation just as it does for any other type of property. Other vehicles registered under the IRP but not owned by public service companies are billed for property taxes like other classified motor vehicles. Once the combined system is in place, the valuation of IRP vehicles owned by public service companies will continue to be assessed by the Department of Revenue. All other IRP vehicles will be listed by the owner during the regular January listing period in the county in which the vehicle is located, and taxes will be due at the same time as taxes on other personal property.

Interest Credited to Combined Motor Vehicle and Registration Account

The act provides that interest generated by the funds in the Combined Motor Vehicle and Registration Account shall be credited to the Account. This Account was created within the Treasurer's Office, effective January 1, 2006, and holds funds generated by 60% of the first month's interest collected on unpaid taxes on motor vehicles registered under the current staggered system.[63] This interest accrues at the rate of 5%, and the funds generated by the interest are to be used for the purpose of developing and implementing the integrated computer system necessary to implement the combined motor vehicle registration and property tax collection system.

This portion of the act became effective when signed into law by the Governor on August 29, 2007.

Transfer of Funds in Combined Motor Vehicle and Registration Account

The 2005 legislation authorized the North Carolina Association of County Commissioners to direct the State Treasurer to distribute the funds in the Combined Motor Vehicle and Registration Account to the DMV for the purpose of developing and implementing the integrated computer system. The act gives the Office of State Budget and Management (OSBM) this authority; however, the funds in the Account may not be transferred by the OSBM and appropriated by the General Assembly until the Department of Transportation and the North Carolina Association of County Commissioners reach agreement on a project plan for the integrated system. Any funds remaining in the Account after the integrated system has been certified to be in operation must be distributed to the local governments on a pro rata basis.

This portion of the act became effective when signed into law by the Governor on August 29, 2007.

[63] Under the current system, property taxes for the 12-month period that begins the first month following vehicle registration or renewal become due four months after the registration or renewal.

Property Tax - School Capital Leases.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-477	**HB 63**	**Rep. Yongue, Johnson, Jones, Lucas**

OVERVIEW: This act excludes from property tax all real and personal property that is subject to a capital lease and used as a public school facility. The act was a recommendation of the House Select Committee on Public School Construction.

FISCAL IMPACT: This act does not impact State revenues and is expected to have no significant fiscal impact on local revenues. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act is effective for taxes imposed for taxable years beginning on or after July 1, 2007.

ANALYSIS: This act excludes from property tax all real and tangible personal property that is subject to a capital lease and is used as a public school facility.[64]

In 2006, the General Assembly expanded the financing authority of local school administrative units by allowing them to enter into capital leases for school facilities.[65] These leases may relate to an existing building or new construction. Capital leases differ from operating leases in several respects. In general, a capital lease is one that is considered to have the economic characteristics of ownership. To determine whether a lease is a capital lease or an operating lease, one must look at a number of different provisions in the lease. Under generally accepted accounting principles, a capital lease is a non-cancelable contract satisfying one or more of the following conditions:

- Legal title to the property is transferred to the lessee.
- The lease contains bargain or nominal purchase options.
- The lease term equals or exceeds 75% of the asset's useful life.
- The present value of the minimum lease payments equals or exceeds 90% of the asset's fair market value.

Because a capital lease is generally considered to have the economic characteristics of ownership, the current practice of counties has been to treat the lessee in a capital lease as the responsible party for the payment of property taxes. Therefore, in the case of a school capital lease, the local school administrative unit is considered the owner for tax purposes and the property subject to the capital lease is excluded from property taxes. Generally, property owned by a unit of local government is not subject to property tax, and a local

[64] The most common type of tangible personal property that is subject to a capital lease by a school facility is its stadium lighting system.

[65] S.L. 2006-232, as amended by S.L. 2006-259. Prior to 2006, school boards were allowed to enter into operating leases for school facilities, but the property on which the facilities were located had to be owned in fee simple by the local unit. In addition, all construction and repairs were required to be performed under the control and direction of the local board of education.

school administrative unit is a unit of local government. This act does not affect the current practice of counties.

Enact WASC Recommendations.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-485	**SB 646**	**Senator Albertson**

AN ACT TO PROVIDE PROPERTY TAX RELIEF FOR WORKING WATERFRONT PROPERTY, TO ESTABLISH THE ADVISORY COMMITTEE FOR THE COORDINATION OF WATERFRONT ACCESS, TO MAKE EXPANDED PUBLIC ACCESS TO COASTAL WATERS A PRIORITY IN PLANNING STATE ROAD PROJECTS, TO INCREASE FEES FOR VESSEL TITLING, TO WAIVE PERMIT FEES FOR EMERGENCY COASTAL AREA MANAGEMENT ACT PERMITS, AND TO DIRECT A STUDY OF CONSTRUCTION AND REPAIR IN REGULATED FLOOD ZONES, AS RECOMMENDED BY THE WATERFRONT ACCESS STUDY COMMITTEE.

OVERVIEW: Section 1 of the act provides property tax relief to working waterfront property by classifying the property as a special class of property to be appraised, assessed, and taxed on the basis of its value in its present use as opposed to its true value. The remainder of this act does not affect North Carolina tax laws and is not discussed below.

FISCAL IMPACT: Section 1 of the act does not impact State revenues. No estimate is available for the impact on local revenues, since there is no available data regarding the acreage or value of working waterfront property. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: Section 1 of the act is effective for taxes imposed for taxable years beginning on or after July 1, 2009.

ANALYSIS: The act classifies working waterfront property as a special class of property that must be appraised, assessed and taxed at its present use value as opposed to its true value. Working waterfront property is any of the following property that has, for the most recent three-year period, produced an average gross income of at least $1,000:

- A pier that extends into coastal fishing waters[66] and limits access to those who pay a fee.
- Real property that is adjacent to coastal fishing waters and is primarily used for a commercial fishing operation[67] or fish processing, including adjacent land that is under improvements used for one of these purposes.

[66] 'Coastal fishing waters' are defined in G.S. 113-129 as the Atlantic Ocean; the various coastal sounds; and estuarine waters up to the dividing line between coastal fishing waters and inland fishing waters agreed upon by the Marine Fisheries Commission and the Wildlife Resources Commission.

Working waterfront property also includes land reasonably necessary for the convenient use of the property. In order for the land to be classified as working waterfront property, the owner must submit an application to the tax assessor of the county in which the property is located and the assessor must approve the application. A new application is not required to be submitted unless the property is transferred or the property loses its eligibility for classification as working waterfront property. Deferred taxes become due on the property when it no longer qualifies as working waterfront property. At that time the owner must pay the deferred taxes for the preceding three fiscal years. In addition, the tax on the property for the fiscal year that opens in the calendar year that the deferred taxes become due is computed as if the land had not been classified as working waterfront property. Deferred taxes are the difference between the taxes due on the property taxed at its present use value and the taxes that would be due if the property were taxed at its true value.

Since 1973, the General Assembly has established only three classifications of property that are eligible for present-use value tax treatment. Agricultural land, horticultural land, and forestland that meet certain size and ownership requirements and that are actively engaged in commercial production are eligible for this property tax benefit. Agricultural land and horticultural land must also meet the following minimum income requirement: for the preceding three years: an average gross income of at least $1,000. The purpose of these classifications was to help preserve farmland by insulating it from the rising property tax values caused by competing market pressure to develop farmland for commercial and residential purposes.

Reform Tax Appeals.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-491	**SB 242**	**Senator Clodfelter**

AN ACT TO REFORM THE PROCESS FOR ADMINISTRATIVE AND JUDICIAL REVIEW OF DISPUTED TAX MATTERS.

OVERVIEW: This act substantially revises the process for the review of disputed tax matters to provide taxpayers with the opportunity for an independent hearing outside the Department prior to paying the tax. These revisions include administrative review by the Office of Administrative Hearings, the elimination of the Tax Review Board, and the referral of tax cases to Business Court. With the elimination of the Tax Review Board, the act authorizes the Secretary of Revenue to approve a multistate corporation's request to use an alternative apportionment formula for franchise and corporate income tax purposes. It also extends by one month the due date for filing corporate income and franchise tax returns and makes various changes to the tax collection statutes.

[67] 'Commercial fishing operation' is defined in G.S. 113-168 as any activity preparatory to, during, or subsequent to the taking of any fish, the taking of which is subject to regulation by the Marine Fisheries Commission, either with the use of commercial fishing equipment or gear, or by any means if the purpose of the taking is to obtain fish for sale. It does not include (i) the taking of fish as part of a recreational fishing tournament, unless commercial fishing equipment or gear is used, (ii) the taking of fish under a Recreational Commercial Gear License, or (iii) the taking of fish as provided in G.S. 113-266 (Taking fish and wildlife for scientific purposes; permits to take in normally unauthorized manner; cultural and scientific operations).

FISCAL IMPACT: No impact.

EFFECTIVE DATE: Generally, the new procedures for disputing tax matters become effective January 1, 2008, and apply to assessments that are not final as of that date and to claims for refund pending on or filed on or after that date. The provisions relating to a federal determination are effective for taxable years beginning on or after January 1, 2007. The corporate income and franchise tax filing extension is effective for taxable years beginning on or after January 1, 2008.[68]

ANALYSIS:

Part I: Reform the Administrative and Judicial Review of Disputed Tax Matters

Prior Law

Before turning to an explanation of the new act, the following is an explanation of the prior law.[69] The prior tax appeals system was divided among assessments, refund claims for overpayments, and refund claims for the payment of an unconstitutional tax. Each type of claim involved a different procedure.

Assessments. – Upon receipt of a notice of a proposed assessment, a taxpayer could request a hearing before the Secretary of Revenue. Prior to scheduling a hearing, the Department attempted to resolve the matter informally through phone conversations, letters, and conferences. If those negotiations were unsuccessful, the case proceeded to a hearing at the Department. In practice, the Secretary did not hold the hearing. Instead, the Secretary exercised the authority given in G.S. 105-260.1 and delegated the responsibility of conducting the hearing and making a decision to an Assistant Secretary of the Department, who served as the Department's hearings officer. As an Assistant Secretary of the Department, this hearings officer was located within and employed by the Department. At the hearing, a taxpayer could be represented by an attorney, an accountant, or any person who has power of attorney for the taxpayer. The rules of evidence did not apply. The hearings officer had no authority to decide constitutional issues. The hearings officer was required to issue a written decision within 90 days of the hearing. This decision was considered the Secretary's decision.

A taxpayer who was dissatisfied with the Secretary's decision had two options. One option was to obtain an administrative review of the decision by the Tax Review Board, which was a three-member board consisting of the State Treasurer, the Chair of the North Carolina Utilities Commission, and an appointee of the Governor. The Tax Review Board held a hearing, but based its review on the record established at the Department. The Tax Review Board issued a decision within 90 days after the hearing, and the decision could be appealed to superior court. Under this option, the superior court reviewed the Tax Review Board's decision based on the record created at the Department. A taxpayer did not have to pay the proposed assessment while the case was under review. The other option was to bring an action in superior court within 30 days after notification of the Secretary's hearing decision. Under this option, the action in superior court was *de novo*.

[68] See Part III. of the Analysis for an explanation of a technical correction that is needed.

[69] As used in this Analysis, 'prior law' refers to the law that is in effect until January 1, 2008, when S.L. 2007-491 becomes effective.

Decisions of the superior court may be appealed to the North Carolina Court of Appeals and then to the North Carolina Supreme Court. The procedures for appeal from the superior court were the same, regardless of whether the action in superior court was based on the record established at the Department or was a *de novo* action.

Refunds. – The procedure for obtaining a refund of tax paid by a taxpayer differed depending on the nature of the claim. A taxpayer challenging the constitutionality of a tax had to follow the procedure set out in G.S. 105-267, known as the 'payment under protest rule'. If the taxpayer claimed that the tax paid was incorrect or excessive, then G.S. 105-266.1 governed the refund procedure. Under both statutes, the taxpayer was required to apply to the Secretary in writing for a refund. Under G.S. 105-267, the refund request had to be made within three years after payment.[70] Under G.S. 105-266.1, the refund request had to be made within three years after the filing date of the return or within six months after payment of the tax, whichever was later.[71] At this stage, the procedure varied as follows:

1. *Payment under protest (G.S. 105-267).* – When a refund request was made, the Secretary had 90 days to issue a decision and refund the tax in accordance with the decision. If the tax was not refunded within 90 days, the taxpayer could file a civil action at any time within three years after the expiration of the 90-day period allowed for making the refund. Thus, the three-year period for requesting a refund when coupled with the period for filing an action gave a taxpayer a maximum of six years and 90 days to contest the tax. If upon trial it was determined that all or part of the tax was levied for an 'illegal or unauthorized purpose', judgment was entered for the taxpayer, and the State refunded the amount of the judgment.
2. *Refunds for overpayment (G.S. 105-266.1).* – The appeals route for overpayment claims was similar to the route for assessments. When a refund request was made, the Secretary reviewed the request and notified the taxpayer of the decision. If the refund was reduced or disallowed, the taxpayer could request a hearing. The Department was required to schedule a hearing within 90 days, unless the taxpayer and the Secretary agreed to a later date. Within 90 days of the hearing, the Secretary made a decision, notified the taxpayer, and adjusted the tax in accordance with the decision. A taxpayer aggrieved by the Secretary's decision could, within 90 days after notification of the decision, either petition for administrative review before the Tax Review Board, followed by appeal to superior court on the record, or bring a *de novo* civil action against the Secretary for recovery of the alleged overpayment. Either party could appeal to the appellate division from the judgment of the superior court.

The New Law

Effective January 1, 2008, Session Law 2007-491 repeals the current statutes governing the process for administrative and judicial review of disputed tax matters and replaces them with a new procedure. Under this act, the procedure for the review of a

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[70]The protest period for taxes paid on alcoholic beverages, tobacco products, and controlled substances is only 30 days after payment.
[71]The statute of limitations period varies for overpayments associated with worthless debts or securities, capital losses and net operating losses, and returns reflecting a federal determination.

proposed assessment and a request for a refund are substantially the same. The key features of the new procedure are as follows:

Claims for refunds. – The prior procedure required a taxpayer who was requesting a refund either for an overpayment or for a tax paid under protest to apply to the Secretary in writing. However, the prior statutes did not provide any guidance on the format or the content of the request. In addition, the statute of limitations for requesting a refund differed depending on the nature of the claim.

Under the act, all requests for refunds are treated the same. A taxpayer may request a refund either by filing an amended return or by filing a written claim for a refund within the appropriate statute of limitations. The claim must identify the taxpayer, the type and amount of tax overpaid, the filing period to which the overpayment applies, and the basis for the claim. The statement of the basis does not limit the taxpayer from changing the basis. The act changes the statute of limitations to mirror federal law, which is the later of three years after the due date of the return or two years after payment of the tax.[72] The Department must take action on the refund claim within six months. If it does not, the inaction is considered a proposed denial of the refund claim. Under prior law, there was no time limitation on the Department of Revenue for responding to a refund claim.

Proposing assessments. – For the most part, the procedure by which the Department proposes an assessment is substantially the same under the act as under prior law. If the Department discovers that tax is due, it may propose an assessment within the statute of limitations by sending written notice to the taxpayer stating the basis for the assessment. Language has been added to provide that the statement of basis does not limit the Department from changing the basis at a later time. The statute of limitations for proposing an assessment is also the same in this act as under prior law, which is also the same as federal law.

Departmental review. – As a general matter, when a taxpayer objects to a proposed assessment or a denial of a refund claim, the administrative practice of the Department has been to work with the taxpayer in an attempt to resolve the matter informally. However, this practice has not been codified in statute until now. Senate Bill 242 sets out a review and conference procedure and establishes a specific time frame by which certain actions must occur. Codifying the procedure in this manner is designed to provide taxpayers with more guidance, more transparency, and more predictability with regard to the process.

Under the new process, a taxpayer who objects to a proposed denial of a refund or a proposed assessment may, within 45 days from the notice, file a request for review by the Department. This time limit provides the taxpayer with an additional 15 days compared to prior law.[73] If a taxpayer fails to request a review of a proposed denial of a refund or a proposed assessment, then the proposed actions of the Department become final. Once a

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[72] The Department of Revenue has indicated that if a taxpayer's right to receive a refund expired under the prior six-month statute of limitations, the new two-year statute of limitations does not reopen the taxpayer's right to a refund. (See the Department of Revenue's *2007 Tax Law Changes*.)

[73] The Department has indicated that taxpayers who filed timely protests of proposed assessments or denials of refunds before January 1, 2008 and that are still pending as of that date are not required to submit a new request. (See the Department of Revenue's *2007 Tax Law Changes.)*

proposed denial of a refund becomes final, the taxpayer may not file another amended return or claim for refund to obtain the denied refund. Once a proposed assessment becomes final, a taxpayer may not seek further administrative or judicial review of the assessment. However, the taxpayer may pay the tax and seek a refund. The Department is required to send the taxpayer a 'notice of collection' indicating that the assessment is final and collectible and stating the collection options available to the Department.

A taxpayer who requests a review initiates a two-step process consisting of an initial review followed by an informal conference. If the initial review results in the Department granting the refund or removing the assessment, the matter ends there. If the initial review does not resolve the dispute, the Department may request additional information from the taxpayer and must schedule a conference with the taxpayer. With regard to a refund claim, if a taxpayer does not respond to the Department's request for additional information, the Department may deny the claim and send a notice of proposed denial. If the taxpayer provides the information, then the Department has additional time to take action on the request, including a time period mutually agreed upon by the parties. The conference is intended to be an informal process in which the Department and the taxpayer attempt to resolve the matter. The taxpayer does not need to appear in person and may designate a representative to appear with the taxpayer or on the taxpayer's behalf. If the Department and the taxpayer are unable to resolve the matter at conference, the Department issues a final determination.

Final determination. – A final determination represents the Department's decision regarding a proposed denial of a refund or a proposed assessment. It must be issued within nine months after the date the taxpayer filed a request for review.[74] Once issued at the conclusion of the Departmental review process, it triggers the taxpayer's ability to seek further review. The final determination must state the basis for the determination and inform the taxpayer of the procedure for contesting it. A final determination regarding a proposed assessment must state the tax, interest, and penalties payable by the taxpayer, inform the taxpayer that the tax liability is due and collectible, unless the taxpayer contests the final determination, and explain the collection options available to the Department. This process of Departmental review, which may include a conference and concludes with the issuance of a final determination, is considered a taxpayer's 'prehearing remedy'. A taxpayer must exhaust this prehearing remedy before seeking review of an adverse final determination by the Department.

Contested case hearing. – The act establishes OAH as the independent forum for the review of contested tax matters. Under prior law, the Department of Revenue was exempt from the contested case hearing procedures of the Administrative Procedure Act. Instead, the administrative review of a disputed tax matter was conducted by a hearings officer within the Department followed by appeal to the Tax Review Board. A taxpayer also had the option of bypassing this administrative review process by paying the tax and filing a civil action in the superior court. Under the new system, this option is eliminated. There are several reasons why allowing a taxpayer to bypass the administrative review process and proceed directly to court is not a desirable feature of a fair and efficient tax administration

[74] With regard to requests for review that are pending as of January 1, 2008, the Department has nine months from January 1, 2008 to conclude its review and issue a final determination. (See the Department of Revenue's *2007 Tax Law Changes*.)

system. First, it is contrary to the fundamental principle of administrative law that one must exhaust his or her administrative remedy before filing suit. Second, allowing a taxpayer to use judicial resources to develop a record, when that record could be developed at a lower level, is in inefficient use of judicial resources. Third, allowing a taxpayer to bypass the Departmental review process may adversely impact the Department's ability to have its best case prepared. Finally, it encourages forum shopping. Taxpayers with the financial ability to pay the tax should not be able to seek review in a different forum than a taxpayer who does not have the financial ability to pay. For these reasons, the new process requires taxpayers to exhaust the prehearing remedy and then file a contested case with OAH before filing suit.

The contested case follows the procedure set forth in Article 3 of Chapter 150B of the North Carolina General Statutes, which is the same procedure for virtually all other agency-citizen disputes. This includes a fact-finding hearing before an administrative law judge (ALJ) who issues a decision. The ALJ decides the case based on a preponderance of the evidence, giving due regard to the demonstrated knowledge and expertise of the agency with respect to facts and inferences within the specialized knowledge of the agency. The ALJ's decision is returned to the agency for a final decision. The Department of Revenue must publish final decisions in contested tax cases in redacted form to remove identifying taxpayer information.

In 2000, the General Assembly made significant changes to the APA, which included strengthening the weight that must be given to ALJ decisions by agencies when making final decisions. Specifically, the agency must adopt each of the ALJ's findings of fact unless the finding is "clearly contrary to the preponderance of the admissible evidence giving due regard to the opportunity of the administrative law judge to evaluate the witnesses' credibility." In addition, the agency may not reject, substitute, or make new findings of fact unless it specifically states the reason for not adopting the ALJ's finding of fact and cites the evidence in the record on which it relied.

The agency must adopt the ALJ's decision unless it demonstrates that the decision is clearly contrary to the preponderance of the evidence in the admissible record. If the agency does not adopt the ALJ's decision, the agency must set forth its reasoning in light of the findings of fact and conclusions of law, including any exercise of discretion by the agency.

The act includes some special provisions for contested tax cases heard at OAH. First, it gives the Chief Administrative Law Judge general authority to simplify the procedures that apply to a contested tax case involving a taxpayer who is not represented by an attorney. It also requires an ALJ assigned to a contested tax case to make reasonable efforts to assist unrepresented taxpayers. Second, it requires the venue for all contested tax cases to be Wake County, unless the parties agree otherwise. Third, it provides that the record, the proceedings, and the decision are confidential until the final decision is issued in the case. Fourth, it allows a law enforcement report to be admitted into evidence without the testimony of personnel from the law enforcement agency. Finally, it creates an exemption in the confidentiality statute regarding taxpayer information for purposes of complying with an order of an ALJ in a contested tax case.

Judicial review of final decision. – Article 4 of Chapter 150B of the North Carolina General Statutes authorizes a person who is aggrieved by a final decision in a contested case to seek judicial review in the Superior Court of Wake County or in the county in which the person resides by filing a petition within 30 days after being served with the decision. This act allows a taxpayer to seek judicial review of a final decision by the Department in accordance with that Article. Prior to seeking judicial review, the taxpayer is required to pay the tax, penalties, and interest due. The prior option of posting a bond in lieu of paying the tax, penalties, and interest is repealed by this act. Also, the taxpayer is limited to filing a petition in the Superior Court of Wake County, but the taxpayer may request referral to the Business Court. A taxpayer may appeal a decision of the Superior Court, which includes decisions of the Business Court, to the North Carolina Court of Appeals.

When the General Assembly amended the APA in 2000, those changes included changing the court's standard of review of final agency decisions to reflect the higher standard to which agencies are held in order to reject an ALJ's decision. If the agency rejects an ALJ's decision, the court must review the record *de novo* and make its own findings of fact and conclusions of law. The court may not give deference to any prior decision in the case, nor is it bound by the agency's findings of fact or conclusions of law.

Tax cases in Business Court. – The North Carolina Business Court is a specialized forum of the North Carolina State Court's trial division. Currently, the Business Court handles only cases that involve complex and significant issues of corporate and commercial law, which are assigned by the Chief Justice of the North Carolina Supreme Court and designated 'complex business cases'. This act adds tax cases to the list of matters that may be designated as complex business cases and taken up by the Business Court. This change is designed to provide both taxpayers and the State with a specialized forum for tax cases where it is anticipated that the court will develop expertise in this often complex area of the law.

Civil actions and constitutional claims. **–** With some limitation, prior law allowed a taxpayer to pay a disputed tax and bring a civil action in the superior court in lieu of administrative review. Under the new law, a taxpayer is required to exhaust the administrative remedy first by seeking Departmental review and commencing a contested case hearing at OAH. All matters, except for a challenge to the constitutionality of a statute on its face, are resolved through judicial review of the record created at OAH.

Generally speaking, the constitutionality of a statute may be subject to a 'facial' or an 'as applied' challenge. With an as applied challenge, the plaintiff contends that the application of a statute to the person's particular facts and circumstances is unconstitutional. The practical effect of holding a statute unconstitutional, as applied, is to prevent its future application in a similar context, but it does not render the statute utterly inoperative. With a facial challenge, the plaintiff contends that no set of circumstances exists in which the statute may be constitutionally applied.

If the only basis for disputing a tax is that the statute imposing the tax is unconstitutional on its face, the matter may only be resolved by the judicial branch. Neither executive agencies nor OAH, which is a quasi-judicial body within the executive branch, has authority to determine the facial validity of a statute. However, this act does not allow a taxpayer to bypass the Departmental review process or OAH altogether and proceed directly to court when the matter involves a constitutional claim. Under this act, a taxpayer is required to exhaust the administrative remedy before going to court. Therefore, constitutional claims may follow one of two paths under this act:

1. *Application of statute*. – If the claim involves a constitutional challenge to the application of a tax statute, then the taxpayer proceeds with a contested case at

OAH. OAH serves as the fact-finding body and establishes the record in the case. The ALJ makes a decision regarding the application of the statute based on the facts elicited at the hearing. If the final decision is adverse to the taxpayer, the taxpayer has 30 days to file a petition with the Superior Court of Wake County seeking judicial review of the decision. The taxpayer may simultaneously file a Notice of Designation seeking designation as a mandatory complex business case to be heard in the Business Court.

2. *Facial challenge.* – If the claim involves a challenge to the facial validity of the statute, OAH would dismiss the case for lack of jurisdiction. At this point, the tax is collectible. The taxpayer may, within 30 days, seek judicial review of the dismissal. The taxpayer may also, within two years, file a new civil action. In either case, the taxpayer must pay the tax immediately upon conclusion of the case at OAH. A taxpayer who files a civil action in this circumstance may also seek designation of the case as a complex business case to be heard in the Business Court.

***Elimination of Tax Review Board.* –** The act eliminates the Tax Review Board and, by extension, the augmented Tax Review Board.[75] Under the revised review and appeals process, the role of the Tax Review Board is no longer needed because OAH is the independent arbiter of disputed tax matters, and the superior court is the forum for review of final decisions.

Report by Attorney General's Office. – The act directs the Office of the Attorney General to report on or before January 1, 2009, to the Revenue Laws Study Committee concerning the staffing needs of the Revenue Section as the result of the tax hearings being conducted at OAH.

Part II: Changes Relating to Federal Corrections

When the federal government corrects or otherwise determines the amount of an estate, a gift, or income that is subject to tax, the taxpayer must file a State return that reflects the change. This is so because the State estate, gift, and income taxes are, to varying degrees, based on amounts determined with respect to federal law. The change is referred to as a 'federal determination' or a 'federal correction'. This act makes three changes in the law relating to federal corrections, effective for taxable years beginning on or after January 1, 2007.

Limits on refunds and assessments. – The act creates a new provision with respect to claims for refund and to proposed assessments when a federal determination is involved. If a taxpayer files a return reflecting a federal determination that affects the amount of State tax payable and the general statute of limitations for requesting a refund or proposing an assessment has expired, then a request for refund or proposed assessment is limited to the adjustment in State tax payable reflecting the federal determination. In other words, filing a return reflecting a federal determination does not open up a taxpayer's return to all items on that return, but only to those items that changed as a result of the federal determination. Similarly, a taxpayer may not request a refund for items beyond the scope of the federal determination.

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[75] The effect of eliminating the augmented Tax Review Board is discussed in more detail in *Part IV*. of this summary.

Withholding tax. – In 2006, the General Assembly reduced from two years to six months the period of time in which a taxpayer must report a federal change based on a model uniform statute adopted by the Multistate Tax Commission. The model statute was intended to bring uniformity to this area among the states. Currently, there is a great deal of variety with some states requiring changes to be reported in as little as 90 days to as much as two years. The 2006 change inadvertently omitted the statute requiring employers to report federal changes to withholding tax. Section 17 of this act makes that conforming change by reducing from two years to six months the time period that an employer has to report federal changes.

Estate tax. – A taxpayer who fails to file an amended State return reflecting federal changes is subject to the general administrative penalties in G.S. 105-236 and forfeits the right to a refund due as the result of the federal changes. However, a taxpayer who fails to file an amended estate tax return reflecting federal changes is subject only to the loss of the refund. Section 6 of this act makes the federal correction statute for estate tax returns consistent with all of the other federal correction statutes by making failure to file subject to the general penalty provisions.

Part III: Extension of Corporate Income and Franchise Tax Filing Deadline

Sections 10 and 14 of the act extend by one month the due date for filing corporate income and franchise tax returns. With this change, the returns are due on the 15th day of the fourth month following the end of the corporation's tax year rather than on the 15th day of the third month. The change is effective for returns filed in 2009.[76]

Part IV: Alternative Apportionment Formula Requests

With the elimination of the augmented Tax Review Board, a new procedure is established for multistate corporations seeking an alternative apportionment method to determine their North Carolina corporate income and franchise tax liability. The new procedure applies to requests filed on or after January 1, 2008.

Under prior law, if a corporation believed that the statutory apportionment formula subjected the corporation to more tax than is reasonably attributable to its business within the State, it filed a petition with the Tax Review Board. The Tax Review Board, whose membership was augmented by the addition of the Secretary of Revenue, held a hearing, considered the evidence, and rendered a decision by majority vote. Prior to the passage of this act, North Carolina was the only state where this decision-making authority lay outside the Department. If the Tax Review Board concluded that the statutory formula subjected the corporation to more tax than is reasonably attributable to the State, it authorized allocation by an alternative method. The Tax Review Board's decision was not subject to appeal.

Under the new procedure, this role of the Tax Review Board is replaced by the Secretary of Revenue. Just like the prior law where the Tax Review Board's decision could

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[76] A corporation's franchise tax liability is paid for a given tax year in the same year in which the return is filed. Unlike franchise tax, a corporate income tax return reflects the tax due for the preceding year. However, franchise tax and corporate income tax are reported on the same form. Therefore, the due date of those returns must be the same. Questions have been raised with regard to the effective date in Senate Bill 242 for the one-month extension of franchise and corporate income tax returns. Returns filed in 2008 will be due on the 15th day of the third month following the end of the corporation's income year. Effective for taxable years beginning January 1, 2009, returns will be due on the 15th day of the fourth month. However, legislation will likely be introduced during the 2008 Regular Session to make any necessary conforming changes.

not be appealed, the Secretary's decision may not be appealed either. The inability to appeal this decision is consistent with the procedure in the vast majority of other states. If the Secretary authorizes an alternative apportionment method, it applies for no more than three tax years. At the end of the authorization, the taxpayer may renew the request in the same manner as an original request.

Part V: Modifications to Collection Procedures

The Department of Revenue has various collection tools available to it to recover an assessment of tax, including the levy and sale of real and tangible personal property, the attachment and garnishment of intangible property, the filing of a certificate of liability, and the filing of a civil action. This act makes several substantive, clarifying, and technical changes to those collection statutes.

When Tax Is Collectible. – Under prior law, a tax was generally collectible when the Department issued a notice of final assessment. Under the revised review and appeals process, the Department does not issue a final assessment. Therefore, the act sets out the various conditions under which a tax becomes collectible. One of those conditions is when a taxpayer files a return showing tax due but fails to remit the tax due. Under prior law, the Department was required to issue a notice of proposed assessment and follow the procedures for the assessment to become final in order for the tax to become collectible. Under this act, the tax is collectible immediately upon the filing of the return.

The other circumstances under which the Department may collect a tax are as follows: (1) when the Department sends a notice of collection after a taxpayer does not file a timely request for review of a proposed assessment; (2) when a taxpayer and the Department agree on a settlement concerning tax due; (3) when the Department sends a notice of final determination concerning an assessment and the taxpayer does not file a petition for a contested case hearing; (4) when a final decision is issued on a proposed assessment after a contested case hearing; and (5) when OAH dismisses a petition for a contested case for lack of jurisdiction because the sole issue is the constitutionality of a statute on its face.

Garnishment Procedure. – Section 30 rewrites the garnishment statute to make clarifying changes and to more accurately reflect current practice. Under prior law, the Department was required to serve both the taxpayer and the garnishee with a notice of garnishment in accordance with Rule 4 of the North Carolina Rules of Civil Procedure. Under the revised statute, the Department need only send notice by United States mail. Under prior law, a garnishee had 10 days to respond to the notice of garnishment, either by offering a defense or remitting payment due. Under the new procedure, the garnishee has 30 days to comply or file a response. Another new feature is that the Department must send a garnishment release letter that includes identifying information, such as a Social Security number, in the notice. This change will address a concern expressed by employers who are often unable to identify when an employee has satisfied his obligation and is no longer subject to garnishment.

Certificates of Liability. – A certificate of tax liability (CTL) is similar to a civil judgment. Docketed with the clerk of superior court, it acts as a lien on real and personal property. Section 31 of the act makes the following changes:

- Clarifies that CTLs are subject to the legal rate of interest, which is 8%, and not the interest rate set by the Secretary applicable to assessments of tax. This codifies current practice.
- Authorizes the Department to file a CTL in Wake County against a nonresident to assist with collection in a foreign state.
- Provides that a CTL is a lien on both real and personal property from the date it is recorded. Under prior law, a CTL was a lien on real property from the date of docketing and a lien on personal property from the date of levy.
- Provides that the 10-year period in which the CTL is enforceable is tolled if the taxpayer waives the 10-year period. It is tolled until the end of the period extended by the waiver.

Civil Action. – Under prior law, there were two statutes authorizing the Department of Revenue, through the Attorney General's Office, to bring a civil action against a taxpayer to recover a tax debt, one of which applied only with regard to corporations. The act consolidates these two statutes through a rewrite of G.S. 105-243. The revised statute applies to all taxpayers in the same manner. The Department is no longer required to issue a civil execution against a corporation prior to bringing a civil action. Also, the action may be brought in the taxpayer's county of residence or in a court of competent jurisdiction in another state and changes the 'doing business' provision to a county in which the taxpayer has its principal place of business.

Part VI: Refunds of Land Transfer Tax

Section 24 of the act modifies the procedure for a taxpayer seeking a refund for overpayment of the excise stamp tax on conveyances, which is commonly referred to as the 'land transfer tax'. A taxpayer who wishes to request a refund must file a written request with the board of county commissioners of the county where the tax was paid. Under current law, the Secretary of Revenue reviews the board's decision. This act provides for review by the Property Tax Commission. A Property Tax Commission decision may be appealed directly to the North Carolina Court of Appeals.

Part VII: Corporate Officer Authority and Liability

Currently, the following individuals are authorized to sign a corporation's income and franchise tax returns: its president, vice-president, treasurer, assistant treasurer, secretary, or assistant secretary. Section 10 of this act, which applies to franchise tax, adds chief financial officers and deletes the secretary, the assistant secretary, and the assistant treasurer.[77] Section 34 also adds chief financial officers to the list of officers who may be held personally liable for failure to properly remit sales and use, motor fuels, and withholding taxes.

Part VIII: Class Actions Study

Section 45 of the act directs the Revenue Laws Study Committee to study whether any legislative changes should be made regarding the use and scope of class actions to challenge

[77] Conforming changes were not made to the corresponding corporate income tax statute. Since the franchise tax return and the corporate income tax return are on the same form, the statutes need to match. This change will likely be corrected during the 2008 Regular Session.

the constitutionality of a tax in light of the decision reached by the North Carolina Supreme Court in Dunn v. North Carolina. The Committee must report its findings to the 2007 General Assembly, 2008 Regular Session.

Property Tax and PUV Changes and Studies.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-497, as amended by S.L. 2007-484[78]	**HB 1499**	**Rep. Martin, Holliman, R. Warren, Braxton**

AN ACT TO INCREASE THE BENEFIT OF THE PROPERTY TAX HOMESTEAD EXCLUSION BY RAISING BOTH THE INCOME ELIGIBILITY LIMIT AND THE AMOUNT EXCLUDED FROM TAXATION; TO AUTHORIZE THE REVENUE LAWS STUDY COMMITTEE TO STUDY WHETHER AND HOW TO INDEX THE MINIMUM AMOUNT THAT IS EXCLUDED FROM TAX; TO CREATE A SENIOR CIRCUIT BREAKER PROPERTY TAX BENEFIT; TO MODIFY THE PRESENT-USE VALUE REQUIREMENTS FOR AGRICULTURAL LAND USED AS AN AQUATIC SPECIES FARM; AND TO AUTHORIZE THE REVENUE LAWS STUDY COMMITTEE TO STUDY VARIOUS MODIFICATIONS AND EXPANSIONS TO THE PRESENT-USE VALUE SYSTEM.

OVERVIEW: This act provides the following residential property tax relief:

- It increases the amount of the appraised value excluded from the property tax homestead exclusion from the greater of $20,000 or 50% of the appraised value of the residence to the greater of $25,000 or 50% of the appraised value of the residence.
- It increases the income eligibility limit of the property tax homestead exclusion to $25,000 and clarifies the definition of 'income' used to determine this limit.
- It creates a property tax homestead circuit breaker system that defers property taxes on certain owner-occupied homes. An owner who qualifies for both the property tax homestead exclusion and the property tax homestead circuit breaker may elect to take only one of these forms of property tax relief.

The act also provides present-use value property tax status to agricultural land that is used as an aquatic species farm.

Lastly, the act authorizes the Revenue Laws Study Committee to study the following issues:

[78] Section 43.7T.(a) through (e) of S.L. 2007-484 made technical corrections only.

- Whether to index the excluded appraised value limit in the property tax homestead exclusion and, if so, which index to use.
- Ways to address the inability of landowners to pay escalating property taxes while continuing to use their property for farming or other non-developmental purposes.

FISCAL IMPACT:

Description	*Local Government Impact*
Property Tax Homestead Exclusion Changes	$16.5 million loss for 2008-2009 $17.6 million loss for 2009-2010 $18.9 million loss for 2010-2011 $20.1 million loss for 2011-2012
Senior Circuit Breaker Property Tax Benefit	$7.8 million loss for 2009-2010 $7.2 million loss for 2010-2011 $6.8 million loss for 2011-2012
Present-Use Value Changes	No data available; however, the fiscal impact is expected to be minimal.

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)

EFFECTIVE DATE: Except as provided in the Analysis, the act became effective when signed into law by the Governor on August 30, 2007.

ANALYSIS: This act enhances residential property tax relief and modifies the requirements in order for agricultural land used as an aquatic species farm to qualify for present-use value property tax status. The act also authorizes the Revenue Laws Study Committee to study certain aspects of the property tax homestead exclusion and expansion of the present-use value statutes.

Part I: Residential Property Tax Relief

Property Tax Homestead Exclusion. – The property tax homestead exclusion applies to the permanent home of a North Carolina resident who (i) is at least 65 years of age or totally and permanently disabled and (ii) has income not exceeding the income eligibility limit. The amount of the appraised value of the home excluded from property tax is the greater of $20,000 or 50% of the tax value of the home.[79] The income eligibility limit was $18,000 until July 1, 2003. For taxable years beginning on or after July 1, 2003, this limit has been adjusted yearly by a cost-of-living adjustment (COLA) percentage used to increase Social Security benefits for the preceding calendar year. The 2007 income limit is $20,500. The income used to determine the income eligibility limit is a homeowner's adjusted gross income, as defined in the Internal Revenue Code, plus all other moneys received from every source other than gifts or inheritances received from a spouse, lineal ancestor, or lineal descendant.[80] For

[79] A residence owned by husband and wife as tenants by the entirety is entitled to the full exclusion notwithstanding that only one spouse meets the age or disability requirements. If a residence is owned by two or more persons other than husband and wife, each owner who meets the eligibility requirements is entitled to the full exclusion not to exceed the owner's proportionate share of the valuation of the residence.

[80] Section 62 of the IRC defines adjusted gross income as a taxpayer's gross income (all income received from any source other than tax-free income) minus a number of deductions such as capital losses, business expenses, net operating losses, and IRA contributions.

married applicants residing with their spouses, the income of both spouses is included, whether or not the property is in both names.

The act increases the amount excluded from property tax due on a permanent home from the greater of $20,000 or 50% of the tax value of the home to the greater of $25,000 or 50% of the tax value of the home. The income eligibility limit is increased to $25,000, and is indexed for taxable years beginning on or after July 1, 2009.[81] The definition of 'income' used to determine the income eligibility limit is amended by changing the starting point when determining income from adjusted gross income as defined in the Internal Revenue Code to all moneys received from every source other than gifts or inheritances received from a spouse. The amended definition of income prevents a taxpayer from reducing his or her income by net business or other losses subtracted from income on a federal income tax return to arrive at an adjusted gross income figure. The removal of the adjusted gross income as the starting point should affect only a small percentage of taxpayers.

The changes to the property tax homestead exclusion are effective for taxes imposed for taxable years beginning on or after July 1, 2008.

Senior Circuit Breaker Property Tax Benefit. – The act creates a new class of property that qualifies for property tax relief, known as the property tax homestead circuit breaker. The relief is in the form of a deferral of property taxes on the permanent residence owned by a North Carolina resident and becomes effective for taxes imposed for taxable years beginning on or after July 1, 2009.

- Qualifications. The North Carolina resident must have owned and occupied the property located in North Carolina as a permanent residence for at least five years and must be at least 65 years of age or totally and permanently disabled. If the residence is owned and occupied by persons other than husband and wife, the benefit is not allowed unless all of the owners qualify and elect to seek the deferral. An owner qualifying for the circuit breaker property tax benefit and the property tax homestead exclusion must elect which benefit to use.

- Amount Deferred. The amount of property taxes deferred is based on the income eligibility limit of the property tax homestead exclusion. If the owner's income is less than this income eligibility limit, then the portion of property taxes imposed on the residence that exceeds 4% of the owner's income may be deferred. If the owner's income is between 100% and 150% of the income eligibility limit, then the portion of the property taxes on the residence that exceeds 5% of the owner's income may be deferred. The deferred taxes become a lien on the residence. Once a tax deferral has been granted, the county tax assessor must notify the owner each year of the accumulated sum of deferred taxes and interest.

- Disqualifying Event. If the owner transfers the residence, dies, or ceases to use the home as a permanent residence, the deferred taxes for the year in which the transfer, death, or change in use occurs plus the taxes deferred for the preceding three fiscal

[81] The act states that the income eligibility limit is $25,000 until July 1, 2008, and is indexed beginning on or after July 1, 2008. This is contradictory since this portion of the act is effective for taxes imposed for taxable years beginning on or after July 1, 2008. A technical correction will need to be made during the 2008 Session to clarify that the income eligibility limit is $25,000 for tax year July 1, 2008, and indexed for taxable years beginning on or after July 1, 2009.

years become due. The deferred taxes together with interest must be paid within nine months after the disqualifying event occurs. Prepayment of all or part of deferred taxes may be made to the tax collector at any time, with partial payments applied first to accrued interest.

- Exceptions. The deferral is allowed to continue if the owner transfers the residence as part of a divorce proceeding to a spouse who qualifies for tax deferral, the owner transfers the residence to a co-owner of the residence, or the owner dies and passes his or share to a spouse or co-owner. The spouse or co-owner must use the residence as his or her permanent residence and elect to continue deferring payment of the tax. Also, the deferral continues if a qualifying owner ceases to use the residence because of a temporary absence for health reasons or because of an extended absence while confined to a rest home or nursing home, so long as the residence is unoccupied or occupied by the owner's spouse or other dependent. If the owner of a tax-deferred residence does not qualify for the deferral for reasons other than a disqualifying event or if the owner revokes an application for deferral, the owner may not defer any additional property taxes without submitting a new application. The interruption in qualification does not trigger payment of deferred taxes; however, the deferred taxes existing at the time of the interruption will become due when there is a disqualifying event.

Part II: Present-Use Value Changes

Present-Use Value Taxation of Aquatic Species Farms. –The act establishes different production and acreage requirements that must be met in order for agricultural land used as an aquatic species farm to qualify for present-use value taxation. Under the current property tax statutes, agricultural land is one of three classifications that qualify for land taxable at its present-use value (PUV) as opposed to its market value. Agricultural land is defined as land that is a part of a farm unit that is actively engaged in the commercial production of growing of crops, plants, or animals. In order to qualify as agricultural land taxed at its PUV, the land must (i) be individually owned, (ii) consist of one or more tracts, one of which consists of at least 10 acres that are in actual production, and (iii) for at least three years prior to January 1 for the year in which the landowner is claiming PUV, produce an average gross income of at least $1,000.

The act modifies the classification of 'agricultural land' in the property tax statutes to allow different production and acreage requirements for agricultural land used as an aquatic species farm. The tract qualifies for PUV if it meets the existing $1,000 income requirement and either consists of at least five acres in actual production or produces at least 20,000 pounds of aquatic species for commercial sale annually, regardless of acreage. 'Aquatic species' is defined as any species of finfish, mollusk, crustacean, or other aquatic invertebrate, amphibian, reptile, or aquatic plant, and including but not limited to fish and fishes as defined in G.S. 113-129(7).[82]

This change is effective for taxes imposed for taxable years beginning on or after July 1, 2008.

[82] G.S. 113-129(7) defines 'fish' and 'fishes' as all marine mammals, shellfish, crustaceans, and other fishes.

The act authorizes the Revenue Laws Study Committee to study the following issues:

- Whether to index the minimum excluded appraised value limit in the property tax homestead exclusion and, if so, which index to use.[83]
- Ways to address the inability of landowners to pay escalating property taxes while maintaining non-developmental uses of their land such as farming. The study may include a review of implementing tax benefits for donating perpetual easements on property to ensure continuation of non-developmental uses, extending PUV benefits to property that is used for wildlife conservation, and other ways to reduce property taxes to preserve property used for farmland and other non-developmental uses. Any findings, recommendations, or legislative proposals may be reported to the 2008 Regular Session of the 2007 General Assembly.

Exemption For Baler Twine From Sales Tax.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-500	**HB 487**	**Representative Hill**

AN ACT TO EXEMPT BALER TWINE FROM THE SALES AND USE TAX

OVERVIEW: This act exempts baler twine used by a farmer for certain statutory purposes from State and local sales and use tax.

FISCAL IMPACT: Minimal impact on the State and local government revenues. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This act became effective October 1, 2007, and applies to sales made on or after that date.

ANALYSIS: Under current law, the following items are exempt from sales and use tax if they are sold to a farmer[84] for use by the farmer in the planting, cultivating, harvesting, or curing of farm crops or in the production of dairy products, eggs, or animals:

- Commercial fertilizer
- Lime
- Land covers
- Potting soil
- Seeds
- Farm machinery; attachment and repair parts for farm machinery; lubricants applied to farm machinery.
- Horses
- Mules

[83] Existing law indexes only the income eligibility limit of the homestead exclusion. (See G.S. 105-277.1(a2)).

[84] A 'farmer' includes a dairy operator, poultry farmer, egg producer, livestock farmer, farmer of crops, and farmer of an aquatic species as defined by G.S. 106-758.

- Fuel other than electricity.

The act adds baler twine to this list of items exempt from sales and use tax.

Economic Development Modifications.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-515	**HB 1595**	**Rep. Gibson, Owens, Daughtridge, Wainwright**

AN ACT TO CLARIFY PROVISIONS IN THE LOCAL DEVELOPMENT ACT, TO CLARIFY URBAN PROGRESS ZONES AND AGRARIAN GROWTH ZONES, TO ALLOW MORE THAN ONE AGRARIAN GROWTH ZONE IN A COUNTY, TO CLARIFY WHEN THE LAST REPORT IS DUE FOR THE REPEALED LEE ACT CREDITS, TO MAKE TECHNICAL CHANGES CONCERNING THE TAX CREDITS FOR GROWING BUSINESSES; TO PROVIDE FOR PUBLICATION, MONITORING, AND REPORTING ON ECONOMIC DEVELOPMENT INCENTIVE CLAWBACKS; AND TO REQUIRE CLAWBACK PROVISIONS IN LOCAL ECONOMIC DEVELOPMENT AGREEMENTS.

OVERVIEW: This act does the following:

- It clarifies in the Local Development Act a local government's authority to acquire, construct, convey, or lease buildings for industrial or commercial use.
- It clarifies certain criteria for urban progress zones. It also expands the urban progress zones to address districts that have experienced massive layoffs.
- It allows more than one agrarian growth zone in a county.
- It requires a final Bill Lee Act report by the Department of Commerce on June 1, 2007, which is consistent with the Act's repeal.
- It clarifies the effective date for tax credits available under the new Article 3J, Tax Credits for Growing Businesses.
- It provides for publication, monitoring, and reporting on economic development incentive clawbacks.
- It requires clawback provisions in local economic development agreements.*

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The act became effective when signed into law by the Governor on August 30, 2007.

ANALYSIS: The act modifies various economic development incentives.

Authority to acquire, construct, convey, or lease certain buildings. – The Local Development Act of 1925 authorizes counties and cities to undertake specific economic development activities to be funded by the levy of property taxes and by the allocation of other revenues whose use is not otherwise restricted by law. Among those activities is the acquisition, construction, conveyance, or lease of 'shell buildings', which are structures of flexible design adaptable for use by a variety of industrial or commercial businesses. In light of a concern that the term 'shell building' implies or is limited to buildings for general, nonspecific use only, Section 1 of this act eliminates that term. It clarifies that a local government may acquire, construct, convey, or lease any building for industrial or commercial use, regardless of whether the local government has a specific business entity in mind when it acquires, constructs, conveys, or leases a building.

Clarification of criteria for urban progress zones. – In 2006, the General Assembly created a new package of State tax incentives to replace the Bill Lee Act for most taxpayers. As part of that package, the new Article 3J replaced development zones with urban progress zones. Development zones were intended to be areas of high poverty within cities. Over the years it became clear that the development zones often included areas that were neither high poverty nor particularly urban. Under Article 3J, the intent is for urban progress zones to be more narrowly focused and subject to more stringent guidelines with respect to poverty.

Article 3J provides enhanced tax credits in urban progress zones. An urban progress zone is an area that meets certain conditions. One of the conditions seemed to require that the area of the zone zoned as nonresidential could not exceed 35% of the total area of the zone. However, the original intent was not to limit zones to only those areas that have less than 35% nonresidential development, but rather to restrict the size of the zone that did not meet the poverty requirements. According to the Department of Commerce, this wording made it very difficult to create a workable zone. The Department requested that the definition be revised to more accurately reflect the original intent when the act passed last year.

This act addresses the Department of Commerce's concerns by clarifying the definition of an urban progress zone. The act also expands the purpose of an urban progress zone so that it can be used to address districts that have experienced massive layoffs. As amended by this act, an urban progress zone is an area comprised of one or more contiguous census tracts, census block groups, or both, or parts thereof, in the most recent federal decennial census that meets all of the following conditions:

- All land within the zone is located in whole within the primary corporate limits of a municipality with a population of more than 10,000 according to the most recent annual population estimates certified by the State Budget Officer.
- Every census tract and census block group that composes part of the zone meets at least one of the following conditions:
  - More than twenty percent (20%) of its population is below the poverty level according to the most recent federal decennial census.
  - At least fifty percent (50%) of the area of the portion that is within the primary corporate limits of the municipality is zoned as nonresidential and the census tract or census block group is adjacent to a census tract or block group of which

at least twenty percent (20%) of the population is below the poverty level. This portion of the zone cannot exceed 35% of the total area of the zone.

- Its population has a poverty level greater than the poverty level of the population of the State, it population has a per capita income that is at least 10% below the per capita income of the State, and it has experienced a major plant closing and layoff within the past 10 years. A major plant closing and layoff has occurred if an industry has closed one or more facilities in the zone resulting in a layoff of at least 3,000 employees, so long as the number of employees laid off is greater than 7% of the population of the municipality.

Agrarian growth zone changes. – The 2006 legislation that created a new package of State tax incentives also created a new type of zone called an agrarian growth zone, which provides those areas with the enhanced tax credits provided to urban progress zones. The 2006 legislation restricted a county to one agrarian growth zone. This act removes that restriction. An agrarian growth zone must satisfy all of the following conditions:

- It must be composed of contiguous census tracts or block groups located within a single county that does not have any municipality with a population in excess of 10,000.
- Each census tract or block group in the zone must have more than 20% of its population below the poverty level.
- The area of the zone, less its smallest census tract, may not exceed 5% of the total area of the county.

Final Bill Lee Act report. – The Department of Commerce is required to make biennial reports on tax equity and the impact of the Bill Lee Act. With limited exception applicable to four specific industries, the Bill Lee Act is repealed effective for business activities that occur on or after January 1, 2007. The act requires the Department of Commerce to provide a final report on June 1, 2007. Since there are only a few specific businesses that may continue to take Bill Lee credits until 2010, an study of those credits after 2007 would not be representative of the credits' impact or equity.

Clarify effective date of Article 3J. – The repeal of the Bill Lee Act applies to 'business activities' occurring on or after January 1, 2007. The effective date of Article 3J, Tax Credits for Growing Businesses, is for 'taxable years' beginning on or after January 1, 2007. The act clarifies the effective date for Article 3J to avoid any possible gap where, for example, a business with its taxable year beginning on July 1 engaged in otherwise eligible 'business activities' after January 1, 2007.

Clawback provisions. – The act requires the Department of Commerce to publish, monitor, and report on economic development incentive clawbacks. Specifically, it must catalog all clawbacks in the State and federal programs it administers, including a description of each clawback, the program to which it applies, and a citation to its source. The report must be published and updated every six months.

The act also requires economic development agreements entered into between a local government and a private enterprise to contain clawback provisions allowing the local government to recapture amounts appropriated or expended if certain events occur. These events must be specified in the agreement and would include the creation of fewer jobs, the investing of less capital, or the failure to maintain operations at a specified level.

Motor Fuel Tax Exemption for Biodiesel.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-524	**SB 1272**	**Senator Snow**

AN ACT TO EXEMPT BIODIESEL THAT IS PRODUCED BY AN INDIVIDUAL FOR PERSONAL USE IN A PRIVATE PASSENGER VEHICLE FROM THE MOTOR FUEL EXCISE TAX.

OVERVIEW: This act does two things:

- It exempts biodiesel that is produced by an individual for use in a private passenger vehicle from the excise tax on motor fuel.
- It directs a study of transportation funding by the Revenue Laws Study Committee and the Joint Legislative Transportation Oversight Committee.

FISCAL IMPACT: Minimal impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: The motor fuel tax exemption became effective October 1, 2007. The study authorization became effective when the bill was signed into law by the Governor on August 31, 2007.

ANALYSIS: A motor fuel excise tax is imposed on all motor fuels sold, distributed, or used in the State. The rate of tax consists of a flat rate of 17.5¢ per gallon plus a variable wholesale component equal to the greater of 7% of the average wholesale price of motor fuel during a base six-month base period or 3.5¢ per gallon. The wholesale component of the motor fuels tax rate is capped at 12.4¢ per gallon for the period July 1, 2007, through June 30, 2009.

The following are exempted from the excise tax:

- Motor fuel in transport, if the fuel is transported by a licensed distributor or licensed exporter and the supplier of the fuel collects a tax on the fuel at the rate of the motor fuel's destination state.
- Motor fuel sold to the State, the federal government, a county, or a municipality for use by the unit of government.
- Motor fuel sold to local boards of education, charter schools, and community colleges for use by the schools.
- Diesel, in the form of kerosene, when sold to an airport.

The act creates an additional exemption for biodiesel that is produced by an individual for use in a private passenger vehicle that is registered in the individual's name. Biodiesel is any fuel or mixture of fuels derived in whole or in part from agricultural products or animal fats or wastes from these products or fats.

The act also directs the Revenue Laws Study Committee and the Joint Legislative Transportation Oversight Committee to study the issue of providing adequate funding for transportation infrastructure development and improvement. The Committees must report on this issue, including any recommendations or legislative proposals, to the 2008 Regular Session of the 2007 General Assembly.

Revenue Laws & Motor Fuels Tax Tech. Changes.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-527	**SB 540**	**Senator Hartsell**

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS, MOTOR FUELS TAX LAWS, AND RELATED STATUTES.

OVERVIEW: This act makes technical, clarifying, and administrative changes to the revenue laws, the motor fuels tax laws, and related statutes. These changes were a recommendation of the Revenue Laws Study Committee.

FISCAL IMPACT: No impact. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: Except as otherwise specified, this act became effective when signed into law by the Governor on August 31, 2007.

ANALYSIS:

Part I: Technical Changes

Section	Explanation
1	Deletes reference to a repealed statute.
5	Substitutes the defined term 'apportionable' for the term 'business'.
7	Substitutes the defined term 'business property' for term 'machinery and equipment'. (See additional explanation for this section in *Part II: Clarifying Changes*).
8	Substitutes the appropriate reference 'out of', for the prior reference 'to'.
19	Substitutes the correct statutory reference.
20	Repeals an unnecessary statute. Article 3 of Chapter 119 directs the Commissioner of Agriculture to inspect alternative fuel, motor fuel, and kerosene to protect the public. This statute says that various fuels are subject to inspection. It does not appear to be a necessary statute because the provisions of Article 3 govern what fuel is inspected and what standards the fuel must meet. The terms 'alternative fuel', 'motor fuel', and 'kerosene' are

	defined terms in Article 3.
23	Corrects a statutory reference.
27	Corrects a statutory reference.
30	Repeals an obsolete statute. The statute was enacted to facilitate a transition from the sales tax imposed on the gross receipts of motor vehicle leases prior to 1989 and the highway use tax.
32	Repeals an obsolete statute. These reimbursements were repealed in 2001 as part of the agreement on the third one-half cent local option sales tax.
36	Removes an unnecessary citation that is in the statute due to redlining errors.
37	Inserts the correct corporate name of the North Carolina State Art Society, Incorporated.
42	Corrects a statutory reference.

Part II: Clarifying Changes

2	Clarifies the term 'nonprofit arts organization' in the area of exemptions from the gross receipts tax on amusements.
3	Clarifies the duration of an arts festival and a community festival, for purposes of the exemption from the gross receipts tax on amusements. Under current law, the festival may not last more than seven days. This provision clarifies that the festival may not last more than seven *consecutive* days.
4	Clarifies that the allocation of tax proceeds from the excise tax on fortified wine to the NC Wine and Grape Growers Council occurs before the revenues are distributed to counties and cities in which the retail sale of alcoholic beverages are authorized to be sold.
6-7	Clarifies that for the purposes of granting credits for the creation of new jobs, urban progress and agrarian growth zones should be treated separately from other eligible establishments.
10	Adds ancillary services to items for which the sales tax exemption for State agencies does not apply, in order to conform to the changes made in S.L. 2006-33. S.L. 2006-33 separated ancillary services from telecommunications services to conform to the Streamlined Sales Tax Agreement. The change does not alter the taxation of these services.
11	Clarifies the dollar threshold for filing monthly sales tax returns.
12	Clarifies that the payment of use tax on purchases of boats and airplanes is not made on the use tax line of the income tax return. The payment of use tax on these items is due by the 20th day of the month following the purchase. Boats and aircraft are registered, and the Department examines information on registration to verify that use tax has been paid.

13	Clarifies that the 1% privilege tax on the purchase of equipment by a research and development company applies to equipment that would be considered mill machinery parts and accessories as well as mill machinery itself. The tax was intended to correspond to the property used by manufacturers for research and development. This section became effective July 1, 2007, which is the date that the 1% privilege tax began to apply to equipment purchased by a research and development company. Prior to this date, the equipment was subject to the State and local sales tax.
14	Exempts State agencies from the privilege tax imposed on mill machinery. The Department has interpreted the sales tax exemption for State agencies to also apply to this tax since the tax was established when these products were exempted from the sales tax in January 2006 to conform with the Streamlined Sales Tax Agreement. Under the Agreement, the State must have uniform rates. Rather than increase the tax rate on these items, they were exempt from sales tax and subject to this new privilege tax. The Department of Correction industries constitute manufacturing plants and thus purchase equipment subject to this tax.
22	Rewrites G.S. 105-330.10 to incorporate changes made in S.L. 2006-30.

Part III: Administrative Changes

9	Alters the documentation process for the credit for recycling oyster shells to reflect the current Department of Revenue practice. DENR maintains the information for the Department so that this general requirement is not necessary.
21	Conforms the date a local occupancy tax return and tax is due to the date that the sales and use tax is due. This section became effective January 1, 2008.
24	Conforms the effective date for a 2006 change to the confidentiality provisions to administrative practices.
25	Repeals the sunset of the highway use tax provisions contained in the 1989 session law. When the highway use tax was enacted, it was believed the highway projects could be completed in 13 years. It has been 18 years. The 1989 session law would repeal the highway use tax, the Transportation Oversight Committee, and various motor vehicle fees when contracts for all projects specified in Article 14 of Chapter 136 have been let and sufficient revenue has been accumulated to pay the contracts. The various fees have been amended several times since 1989. Based upon this sunset language, the fees would revert to their pre-1989 amounts at some undetermined point in the future. At this point, the sunset creates a 'trap for the unwary'.
26	Makes a change in the reporting requirements for the State Ports Tax credit. Based upon conversations with the Tax Research Division, the change will better enable it to report information to the General Assembly for purposes of determining the credit's effectiveness. The report language was added in

	S.L. 2005-429.
28	Allows local governments to correct errors in their certification of cable television revenues submitted to the Department of Revenue. The certification of the amount of cable franchise tax imposed had to be made by March 15, 2007. Many local governments are in the process of auditing their cable franchise taxes. As a result of those audits, many are discovering errors in their certifications. This provision allows local governments to submit a new certification on or before April 1, 2008. This provision has been requested by the League of Municipalities and agreed upon by the Department of Revenue.
31	Conforms the provisions for making an electronic funds transfer to the changes made in S.L. 2006-66. Last session, the General Assembly replaced the semimonthly sales tax payment for franchise tax and sales tax with a single monthly payment and a prepayment of the next month's liability due on the same day as the monthly payment. The change was made at the request of several large retailers in the Streamlined Sales Tax Project.
33-35	Makes two changes to the tax secrecy provisions at the request of the Tax Research Division of the Department of Revenue. Section 33 allows the Division to share information with other governmental units outside this State for the purpose of statistical reports and revenue estimates. Section 34 allows the Department of Revenue to share information with the Joint Operations Center for National Fuel Tax Compliance (JOC) to better enable the Department to enforce motor fuel tax laws and identify motor fuel tax evasion. The JOC is a partnership of dedicated federal and state fuel tax administration resources. Its membership consists of the Internal Revenue Service, the Federal Highway Administration, and state agencies that are signatories to the Memorandum of Understanding executed to form this organization. The founding membership of the JOC is the IRS, the FHWA, the California Board of Equalization, the NC Department of Revenue, and the Texas Comptroller of Public Accounts. The mission of the JOC is to facilitate state and federal motor fuel tax compliance activities, foster interagency and multi-national cooperation, and provide strategic analyses of domestic and foreign motor fuel distribution trends and patterns. It will work toward these goals through the use of technology to collect, analyze, and share information. Section 35 allows the Division to provide information needed by the Fiscal Research Division of the General Assembly to determine the fiscal impact of proposed legislation. Sometimes, if the fiscal effects of legislation apply only to a limited number of taxpayers, the Division is unable to share the information with Fiscal Research because to do so may, by virtue of the small taxpayer pool, indicate the tax liability of a particular group of taxpayers. The Division would continue to be required to remove any identifying information from the data shared.
39	Repeals the statute that authorizes real estate certificates of participation. RECOP indebtedness is a form of special indebtedness that is intended to be structured so that the principal and a portion of the interest are not paid in installments over the term of the debt. That portion of the interest

	compounds and is payable, along with the principal, only at maturity. The provision was enacted in 2004. The 2004 legislation directed the State Treasurer to conduct a study of RECOP indebtedness and to report to the Joint Legislative Commission on Governmental Operations by February 1, 2005. The Treasurer's Office reported that it did not recommend the State using this form of indebtedness.
40	Repeals the Article creating the Life Sciences Revenue Bond Authority. The Authority was created in 2003. The purpose of the Authority was to determine the best way to establish a credit enhancement program for construction of infrastructure for life sciences manufacturing facilities. The Authority is not functioning. Proponents in the life sciences area agree that the Authority is not needed at this time.
43	Inserts Swain County into the uniform occupancy tax provisions. S.L. 2007-23 amended Swain County's occupancy tax statutes to conform to the uniform law, but it failed to include the county in the list of counties for which the uniform law is applicable.

Part IV: Motor Fuel Tax Changes

15	Provides that the Secretary of Revenue's authority to summon records also applies to the motor fuel tax statutes. The section makes this change by using the defined term 'tax'. G.S. 105-228.90 defines 'tax' includes all of the State levied taxes.
16	Provides that a civil penalty imposed under the motor fuel statutes is payable to the agency that assessed the penalty. In addition to the Department of Revenue, G.S. 105-269.3 provides that the State Highway Patrol, law enforcement officers, and other appropriate personnel in the Department of Crime Control and Public Safety may enforce the motor fuel tax laws. The reorganization of the Division of Motor Vehicles in 2003 moved the State Highway Patrol from DMV to the Department of Crime Control and Public Safety. This substantive change in 2003 necessitated technical, conforming changes to the tax statutes. This section eliminates the need for similar conforming changes in the future.
17	Provides that a fuel alcohol provider and a biodiesel provider need only post a bond to receive a license as a supplier[85] if its annual motor fuel tax liability is at least $2,000. Under current law, to be licensed as a supplier, a fuel alcohol provider or a biodiesel provider must post a bond in an amount that is two times the applicant's average expected monthly tax liability. The amount may not be less than $2,000 and may not be more than $500,000. Under this section, if a fuel alcohol provider or biodiesel provider must post a bond, then the amount would be the same as the current law bond requirement. This section becomes effective October 1, 2007.

[85] A supplier is defined as any of the following: a position holder or a person who receives motor fuel pursuant to a two-party exchange, a fuel alcohol provider, a biodiesel provider, or a refiner. (G.S. 105-449.60)

18	Modifies the defense to imposition of a penalty for failure to obtain a diversion number for motor fuel delivered to a state other than the destination state printed on the shipping document. Under current law, the defense is that the person notified the Secretary of the diversion within seven days after the diversion occurred and timely paid the tax on the diverted fuel.[86] This section removes the seven-day time period by providing that the notification must have occurred prior to the imposition of the penalty. It also removes the requirement that the tax be timely paid if the person assessed with the penalty is the motor fuel transporter because it is not the motor fuel transporter's responsibility to pay the tax. This section became effective when signed into law by the Governor on August 31, 2007, and applies to penalties assessed on or after that date and to refund requests that have not been finally determined as of that date.
38	Repeals a conflicting subdivision. This subdivision imposes the excise tax on motor fuel that is fuel alcohol or biodiesel when it is sold for use. However, these fuels are included in the definitions of gasoline and diesel and should be taxed at the same point in the distribution chain as gasoline and diesel. Current law conflicts as to the point at which these fuels should be taxed. The repeal of this subdivision clarifies that they will be taxed at the terminal rack or at importation. This section became effective January 1, 2008.
41	Corrects an unintended consequence of a motor vehicle law change. S.L. 2007-194 exempted certain trucks from vehicle registration requirements. In so doing, it also exempted them from the requirement that they use tax-paid fuel and from the penalty and enforcement of the motor fuel tax laws. This section provides that although the vehicles do not have to be registered, they still must abide by the motor fuel tax laws.

Solid Waste Management Act of 2007.

Session Law	*Bill #*	*Sponsor*
S.L. 2007-550, as amended by S.L. 2007-543	**SB 1492, as amended by SB 6**	**Senator Clodfelter**

AN ACT TO: (1) TO REPEAL THE EXEMPTION FOR SANITARY LANDFILLS OPERATED BY LOCAL GOVERNMENTS FROM THE REQUIREMENTS FOR ENVIRONMENTAL IMPACT

[86] The General Assembly established this defense in 2005. (S.L. 2005-435.)

STATEMENTS UNDER THE NORTH CAROLINA ENVIRONMENTAL POLICY ACT OF 1971; (2) CLARIFY THE CIRCUMSTANCES UNDER WHICH AN APPLICATION FOR A SOLID WASTE MANAGEMENT PERMIT MAY BE DENIED; (3) PROVIDE THAT SOLID WASTE MANAGEMENT PERMITS ARE NOT TRANSFERABLE WITHOUT THE APPROVAL OF THE DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES; (4) INCREASE THE PENALTIES THAT MAY BE IMPOSED FOR SOLID WASTE VIOLATIONS; (5) REQUIRE THAT AN APPLICANT FOR A PERMIT AND A PERMIT HOLDER ESTABLISH FINANCIAL RESPONSIBILITY TO ENSURE THE AVAILABILITY OF SUFFICIENT FUNDS FOR PROPER DESIGN, CONSTRUCTION, OPERATION, MAINTENANCE, CLOSURE, AND POST-CLOSURE MONITORING AND MAINTENANCE OF A SOLID WASTE MANAGEMENT FACILITY; (6) CLARIFY AND EXPAND THE SCOPE OF ENVIRONMENTAL COMPLIANCE REVIEW REQUIREMENTS; (7) CLARIFY THAT A PARENT, SUBSIDIARY, OR OTHER AFFILIATE OF THE APPLICANT OR PARENT, INCLUDING ANY BUSINESS ENTITY OR JOINT VENTURER WITH A DIRECT OR INDIRECT INTEREST IN THE APPLICANT IS SUBJECT TO FINANCIAL RESPONSIBILITY AND ENVIRONMENTAL COMPLIANCE REVIEW; (8) PROVIDE FOR SITING OF COMBUSTION PRODUCTS LANDFILLS IN AREAS THAT HAVE BEEN FORMERLY USED FOR THE STORAGE OR DISPOSAL OF COMBUSTION PRODUCTS FROM COAL-FIRED GENERATING UNITS AT THE SAME FACILITY THAT GENERATED THE COMBUSTION PRODUCTS, AND TECHNICAL REQUIREMENTS FOR THESE LANDFILLS; (9) AUTHORIZE UNITS OF LOCAL GOVERNMENT TO HIRE LANDFILL LIAISONS; (10) DIRECT THE DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES TO DEVELOP A PROPOSED RECYCLING PROGRAM FOR FLUORESCENT LAMPS; (11) DIRECT THE ENVIRONMENTAL REVIEW COMMISSION TO STUDY ISSUES RELATED TO THE FRANCHISE OF SOLID WASTE MANAGEMENT FACILITIES BY UNITS OF LOCAL GOVERNMENT, TRANSPORTATION OF SOLID WASTE BY RAIL AND BARGE, AND SITING AND TECHNICAL STANDARDS FOR SOLID WASTE MANAGEMENT FACILITIES; AND (12) MAKE RELATED CLARIFYING, CONFORMING, AND TECHNICAL CHANGES.

OVERVIEW: Section 14 of the act establishes a solid waste disposal tax to help offset the cost of the assessment and remediation of pre-1983 landfills and to provide additional resources for solid waste management programs and services. The remainder of this act does not affect North Carolina tax laws and is not discussed below.[87]

FISCAL IMPACT: The new solid waste disposal tax of $2.00 per ton is estimated to generate $25 million annually. *(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2007 Session. Available in the Legislative Library.)*

EFFECTIVE DATE: This tax becomes effective July 1, 2008.

ANALYSIS: Prior to 1983, landfills were not regulated. There exist more than 700 pre-1983 landfills in need of assessment and remediation. Among other things, this act establishes a solid waste disposal tax of $2.00 per ton of waste to be imposed on the disposal of municipal solid waste in landfills in the State and on the transfer of municipal solid waste for disposal outside the State. As amended by S.L. 2007-543, the act allocates the tax proceeds as follows:

- 50% to the Inactive Hazardous Sites Cleanup Fund for the assessment and remediation of pre-1983 landfills.
- 18.75% to cities in the State on a per capita basis to be used solely for solid waste management programs and services.
- 18.75% to counties in the State on a per capita basis to be used solely for solid waste management programs and services. Persons who reside in a city are not counted in the population of the county or counties in which the city is located.
- 12.5% to State agencies and units of local government to initiate or enhance local recycling programs and to provide for the management of difficult to manage solid waste, including abandoned mobile homes and household hazardous waste.

[87] For a summary of those provisions, see Chapter 11 of the *Summaries of Substantive Ratified Legislation* publication available online and in the Legislative Library.

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